

**Accident Compensation Services  
in New Zealand:**

**The Performance of the ACC Scheme and  
Opportunities for Improvement**

**Final report prepared for the Minister for ACC  
by the Steering Group for the  
Stocktake of ACC Accounts**

**30 June 2010**

## Foreword

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The Stocktake group was appointed in July 2009. Our work has taken almost a year. In that time we have examined many issues, learned a great deal, and reached clear conclusions, which are set out in this report.

Over the past eleven months the membership of our group has been enlarged and reduced, advisors have come and gone, our terms of reference have been amended and we have produced two interim reports, the first in February on our progress to date, and the second in April on the issue of competition. This final report summarises all our findings and may be read on its own.

Many have contributed to an exercise of this scale. To name any risks overlooking others. Despite this, for differing reasons, three people must be particularly acknowledged.

Andrew Thompson's sudden death last month shocked his colleagues. His quiet contribution ably represented The Treasury and enhanced our work. He is missed.

Dr Neil Quigley was originally appointed as a member of the group, but he stood down to take up the pen as the principal author of our interim report on competition and this final report. Both reports are the responsibility of the group and reflect our unanimous views. But Neil's expert craftsmanship has greatly facilitated our work.

Last but by no means least I thank Franc Mills, who led an able secretariat and whose own serious accident unhappily reminded us of why this subject matters.

Our terms of reference required that we examine the state of the ACC's finances. The dramatic increase in the Scheme's liabilities highlighted for the Group the volatility inherent in a long-tail scheme of this nature. Even small changes in factors like inflation and earnings can have a major impact on the Scheme's liabilities.

Turning to how such a deterioration can be avoided in future led us to two broad conclusions. The first is that the Scheme's administration needs to focus again on rehabilitation, especially of long-term claimants. Past reviews have identified the same need. This observation and the realisation that the scheme's volatility is inherent in the nature and scale of the Scheme led us to the further conclusion that competition is the only sure means of raising the Scheme's long term financial performance.

Other issues also turn on the question of whether competition is to be allowed, for example the appropriateness of current funding policies.

For the reasons we set out in this report, we have concluded that competition is both feasible and desirable. In our view it is appropriate that the government consider this as a first, threshold requirement. We can retain the compulsory, comprehensive, no fault nature of the accident compensation scheme, including the prohibition on tort liability for personal injury, and

still, with advantage, introduce competition in the Work, Earners' and Motor Vehicle Accounts.  
That is what we recommend.

A handwritten signature in blue ink that reads "David Caygill". The signature is written in a cursive style with a period at the end.

David Caygill  
Chair, Steering Group  
Stocktake of ACC Accounts

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# Executive Summary

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The Steering Group has reviewed a wide range of issues and evidence, and received input from a range of interested parties and expert advisers, bearing on the performance of the ACC Scheme and the causes of the dramatic increase in the outstanding claims liabilities of the Scheme between 2004 and 2009. We have also undertaken a detailed assessment of both the costs and benefits of monopoly public provision, and the merits and feasibility of competitive private delivery, of the ACC Scheme.

The history of the ACC Scheme to date is one of recurring crises resulting from rapid and unaffordable expansion of the claims liabilities of the Scheme followed by periods of greater focus on claims management and rehabilitation. We have recommended improvements to the operation, management, and governance of the current ACC Scheme that will assist in improving its performance. But so long as the current structure of the ACC Scheme is maintained, there is no guarantee that these reforms will prove to be durable across different management and governance regimes, and through different governments. The Steering Group has therefore formed the view that only significant structural reform can ensure the sustainability of the ACC Scheme in the medium and long term.

The Woodhouse Report's conception of a compulsory no-fault scheme providing compensation based on actual losses for all victims of accidents in New Zealand is rightly regarded as a major contribution to public policy in New Zealand. But the Woodhouse Report also contained fundamental flaws in respect of the implementation of those ideas. In particular the problems with the Woodhouse Report include:

- inadequate consideration of the costs of segmenting accident insurance from other parts of the insurance market
- inadequate consideration of the difficulty of defining the boundaries between the ACC and the health and social welfare systems
- failure to consider both the costs of public monopoly provision and the costs of not utilising expertise of the private sector so as to allow private mechanisms to support the social purposes of the Scheme.

The ACC Scheme has social purposes, but it is primarily a compulsory insurance scheme. The Steering Group has reached the view that the accident compensation provided under the ACC Work, Earners', and Motor Vehicle Accounts is properly regarded as insurance because:

- the insured parties can be identified, and a premium paid on behalf of that party
- specific contingencies are insured against, and a specific schedule of benefits is payable in the event of the occurrence of those contingencies
- the contingencies covered are more predictable in a large sample of the population as a whole than they are for any individual

- the frequency and value of claims on the accident compensation scheme are affected by the incentives established by the form and value of the compensation benefits provided.

Viewed from the perspective of social welfare programmes the ACC is distinctive. Social welfare schemes normally provide minimum levels of support regardless of past income, whereas the ACC Scheme provides income-related benefits based on the concept of recompense for losses incurred as a result of an injury. This means that the ACC Scheme is designed to address the opportunity cost of injury not the maintenance of minimum socially acceptable standards of living, and therefore the benefits provided by the Scheme are at much higher levels than social welfare programmes. In addition, social welfare schemes are normally also funded from general taxation, reflecting the explicit cross-subsidies that are embodied in them, whereas the ACC Scheme is funded by levies associated with each individual Account.

The scope of the ACC Scheme, and its regulatory separation from the remainder of the insurance industry in New Zealand, is inefficient. The presence of a state monopoly scheme with coverage as broad as the ACC Scheme has distorted the pattern of insurance purchase for the New Zealand population as a whole, while denying private insurers the ability to offer consumers more efficient packages of insurance cover and to obtain the scope and scale economies that participation in the accident insurance market would provide.

Fully funded premiums to cover accidents that have not yet occurred are required to achieve efficient and sustainable outcomes in an insurance scheme even though pay-as-you-go funding is common for social welfare schemes. Fully-funded premiums are efficient in the sense that they provide a clearer link between the accident experience today and the premiums that are being paid. Fully-funded premiums avoid the inefficiency of departures from actuarially fair pricing and ensure that government and levy payers must face up to the true cost of any changes to the scope or entitlements in the Scheme.

Proponents of pay-as-you go levies to cover accidents that have not yet occurred do not address issues of efficiency in the ACC Scheme, and in particular, do not address the costs arising from the setting of pay-as-you-go levies at rates that do not reflect the cost of the accidents occurring in any period, in any account, or in any industry.

The investment strategy of the ACC has been successful to date. The Steering Group does not support any direct political intervention in the investment policy of the ACC, and in particular considers that any direction to invest in ways that supported government economic development strategies would have the potential to impair the financial stability of the Scheme.

The decision of the Board of the ACC to operate within general public sector accounting guidelines by adopting a 75 percent risk margin in the valuation of the liabilities should be endorsed. The presence of an implicit government guarantee or the ability to impose levies for past unfunded liability are relevant to the solvency of the ACC Scheme because they bear on the likelihood of having assets sufficient to meet the outstanding claims liability, but they are not

relevant to the valuation and the variance of the outstanding claims liability, and it is the latter that the risk margin addresses.

Our analysis of the components of the increase in the outstanding claims liability between 2004 and 2009 may be summarised as follows:

- Only 27% of the \$14.4 billion increase was anticipated by the actuarial valuation in 2004.
- Another 33% of the increase was outside the control of management, being due to changes in accounting standards, economic factors and legislation. These included:
  - changes to accounting standards, primarily the adoption of the 75% risk margin
  - changes to the discount rate used in the valuation (as risk free rates fell during the global financial crisis)
  - changes to the scope of entitlements resulting from legislation and court decisions.

The remaining 40 percent of the increase (\$5.8 billion) was the unanticipated cost increase for social rehabilitation, weekly compensation and medical costs. The drivers for this increase in costs were: the increasing number of new claims, the lengthening duration of claims, and increases in claim costs above inflation. These factors were, to a significant extent, within the power of the ACC to manage (inflation in medical treatment costs perhaps being an exception).

The contribution of new programmes and legislation was significant in financial terms (\$600 million) but a minor proportion of the overall increase in outstanding claims liability.

Social rehabilitation is overwhelmingly the most important single contributor to the increase in outstanding claims liability, representing 32% of the total, and 22% of the \$5.8 billion unanticipated increase in liabilities.

Rehabilitation rates deteriorated across the Scheme in all accounts over the period 2004 - 2009. This had large impacts on the ACC's bottom line as it meant claimants were staying on the Scheme longer and costing more than was expected when levies were set in the past. The recent reversal in this trend under the current Board and management of ACC, together with the relatively high rehabilitation rates achieved from 2002 – 2003 demonstrate the very substantial benefits that can be obtained from a strong focus on effective and efficient rehabilitation programmes. However, the history of the ACC Scheme suggests that without structural reforms this improved level of performance will not be sustainable.

The unanticipated increase in outstanding claims liabilities of \$5.8 billion between 2004 and 2009 dwarfs the losses incurred by any other New Zealand financial institution over the past three years and represents an unacceptable failure of governance, regulation and monitoring. But it would be incorrect to attribute unanticipated cost increases solely to a failure of management, governance and monitoring. Cost increases of this magnitude could only occur in the presence of the systemic weaknesses of the Scheme that we have identified.

The current structure of levies for the Scheme incorporates inefficiently high levels of cross-subsidisation that are impacting on the financial performance and value for money provided by the Scheme. Addressing this problem will require that the practices that are widely used in the insurance industry to increase efficiency and value for money are adopted. In particular, the Steering Group recommends much wider adoption of risk and experience rating across all ACC Accounts. Risk and experience rating are socially desirable in that they have the effect of focusing the attention of employers on improving safety and reducing accidents. There is a wide range of options to introduce risk and experience rating beyond the minimal levels that currently apply to the ACC Scheme.

The Steering Group considers that the introduction of a minimum co-payment is worthy of more detailed examination, both as a reasonable approach to sharing the burden of the Scheme, and as a means of removing the current incentives to report that injuries result from accidents. Investigation of the merits of a comprehensive co-payment would also need to consider whether mechanisms are required to reimburse those on very low incomes for the co-payment, and the costs of doing so.

The Partnership Programme is an example of a programme that enhances efficiency in insurance markets, and that the ACC has adopted from the private insurance sector. However, its implementation by the ACC is flawed, in part because the ACC faces no competitive pressure to ensure that the Partnership Programme works at the optimal level to provide employers with incentives to invest in safer workplaces.

Governance, regulation and monitoring of the ACC can be made more effective. Clearer objectives for ACC management that are more tightly linked to the achievement of the performance targets incorporated into the actuarial valuation, and a focus on ensuring that persons appointed to the Board of the ACC have experience, expertise and sufficient time to be directors of a large and complex insurance organisation will all be of assistance. Monitoring of the ACC by government departments must be more timely, and involve independent analysis of performance by staff with an understanding of financial institutions. Reconstituting the ACC as a State-Owned Enterprise with explicit equity capital and the power to set levies (subject to regulatory oversight) would improve the ability of Ministers to hold the board and management accountable for the overall performance of the Scheme.

Improvement in service provision, especially the management of long-term claims, will have the greatest impact on value for money. This will arise if the ACC is required to focus its efforts much more strongly on early intervention and improving rehabilitation rates, and in particular, on raising return to work rates in the first three months following the accident. This should be seen as part of the full range of changes that we have recommended, all of which will assist in reducing the 'entitlement culture' currently associated with the ACC and returning to a focus on rehabilitation and compensation of actual losses resulting from accidents.

The potential improvements to the existing ACC Scheme that we have suggested will do no more than approximate the benefits the competitive private delivery will provide. This is because the long-term stability of the Scheme requires:

- immunisation from political processes that may reduce Scheme stability and inhibit the pursuit of improved value for money for levy payers
- consumer choice, so that levy payers can respond directly to poor service, inefficient pricing and a lack of innovation
- a wide range of specialist underwriters and service providers who are likely to provide better service in niche markets, including those serving particular ethnic and socioeconomic groups in society.
- the transparency that is associated with private providers, including explicit equity capital and reserves to provide a buffer against short-term variations in financial performance.

Monopoly provision precludes the innovation in claims management and rehabilitation services that is a pre-requisite for financial sustainability in the ACC Scheme because the absence of choice in underwriting and service delivery reduces the pressure on the ACC management and makes it difficult to establish meaningful performance benchmarks. Monopoly provision of accident compensation services also militates against the development and delivery of innovative programmes aimed at specific groups within the community. For example, monopoly provision has to date failed to produce an effective response to the low utilisation of the Scheme by, and the high serious injury rates of, Māori people.

The absence of equity capital in the ACC does not provide the advantages that are sometimes claimed by supporters of the current system. The residual risk that is borne by equity investors in private companies is also present in the ACC, but in the absence of equity investment in the ACC the risks are borne by current levy payers, including many small firms that are not efficient bearers of this risk. The evidence available to the Steering Group does not suggest that premiums will rise as a result of the introduction of competitive private delivery, since the margins required to provide insurers with a return on capital are modest compared to the improvements in the efficiency of premium-setting, and the improvement in accident and rehabilitation rates that could be expected with private delivery.

The Steering Group believes that competitive private delivery of compulsory accident compensation insurance in New Zealand has the ability to address and provide improved outcomes for the ACC Scheme. In particular, competitive private delivery of compulsory insurance would be likely to:

- i Transfer the burden of risk-bearing for unforeseen contingencies and unfunded liabilities arising in the future from current levy payers and the Crown to shareholders of the private insurance companies.
- ii Remove the potential for unfunded liabilities to impact on the Crown's financial performance both directly, by removing the requirement for the privately delivered parts

of the ACC scheme to be consolidated in the Crown's financial accounts, and indirectly by removing the requirement for a Crown guarantee of the liabilities generated by claims in the privately underwritten markets.

- iii Allow for greater transparency in the performance of the accident compensation system, including the setting of premiums that more fairly reflect the risk of the insured party.
- iv Allow competition between insurers and specialist service providers to focus the performance of the compulsory insurance system on investment in accident prevention and rehabilitation in part through the creation of a wider range of options for the use of discounts for investment in accident prevention and experience rating to impact on the premiums actually paid.
- v Create, and ensure a clearer public understanding of the distinction between insurance, that for social purposes the Crown requires employers, members of the workforce or drivers of automobiles to buy, and social welfare. The introduction of private competitive delivery of compulsory insurance into those accounts where it is feasible to use this delivery mechanism would allow a clarification that the remaining accounts may be more appropriately considered to be part of the social welfare net and thus allow their benefits and delivery of these to be reconsidered accordingly (including the potential to transfer these to the pay-as-you-go basis used for other components of social welfare).
- vi Provide and promote greater transparency in community understanding of the true (actuarially fair) cost of providing accident compensation benefits. Changes in the claims experience of each line of compulsory insurance would be reflected more quickly and more transparently in the premiums charged.
- vii Ensure that the disciplines of shareholders in the insurance companies, accounting standards and market regulations precluding the adoption of partially-funded premium levels in response to any extension of benefits or deterioration in claims experience or rehabilitation rates, remove the risk that future generations of firms or levy payers will be required to fund part of the costs of claims resulting from accidents that occurred in the past.

While Māori support retention of the current compulsory no-fault accident compensation system, many Māori are interested in and supportive of the introduction of competitive delivery of accident compensation services, which they characterise as a shift from provider choice (under a monopoly delivery model) to consumer choice (under a competitive delivery model).

The right to sue is not necessary for efficient delivery of insurance by competing private providers. Indeed all of the socially important features of the ACC scheme - compulsory cover, removal of the right to sue, and statutory determination of minimum benefit levels - can be preserved with the introduction of competing private delivery.

Delivery of compulsory accident compensation insurance by private insurers is entrenched in many jurisdictions around the world and operates within a wide variety of legislative and regulatory frameworks. In competitive private delivery compulsory insurance systems, extensive

use of experience-rating and self-insurance forms a key component of the competitive process, as it does in a limited way within the context of the ACC Partnership Programme.

Experience rating and self insurance limit the potential for inefficient cross-subsidies, provide a check on the premiums set by insurers, and provide employers with clearer incentives to invest in accident prevention and effective rehabilitation. Provision for self insurance, with appropriate requirements for stop-loss cover, should be an important part of the introduction of competitive private delivery, including potentially for self-employed high net-worth individuals.

Regulatory separation of insurance provision for different types of accidents is inefficient because it increases the transactions costs of levy payers in obtaining insurance cover and increases the scope for claims to be transferred between different parts of the insurance system. The benefits of competition will therefore be greater the wider is the range of accidents within which competition is allowed.

We consider that it would be feasible and desirable for the insurance industry to take over the business of the Work and Earners' Accounts by 1 April 2012. This is because the common elements in the insurance of workplace and non-workplace injuries to workers, and the adverse selection problems that would be associated with regulatory separation of the Work and Earners' Account, make it highly desirable to introduce competition simultaneously in both Accounts. Competition could be introduced into the Motor Vehicle Account approximately one year later.

The Steering Group does not consider that there is any necessary reason to allow the ACC to operate in the competitive markets. We think that the difficulties involved in ensuring that the Corporation operates on a level playing field with private providers are considerable. This view also applies to the role of residual insurer in the market (ie, the insurer of those who have not obtained insurance) since in other countries the function of residual insurer is undertaken by a private insurer based on a levy of all insurers participating in the market rather than a public entity. However, the ACC will have an ongoing role in the management of the outstanding claims made up to the time when competition is introduced, and the scale of this business alone is substantial.

There is a need for more detailed analysis of a wide range of issues relating to the creation of a market for the insurance currently provided by the ACC, including the way in which the compulsory insurance requirements will be specified, the regulatory and dispute resolution framework for the market, the approach to dealing with uninsured parties, very high or uninsurable risks, catastrophic risk to the market as a whole, and the role of ACC following the creation of this market. The Steering Group suggests that the Department of Labour in conjunction with Treasury should be asked to advise Ministers as to how best to set up an implementation group urgently with access to the necessary range of skills and expertise.

## Recommendations

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The Steering Group for the Stocktake of ACC Accounts recommends that the Minister for ACC:

**Notes that:**

- 1 The Steering Group's views were sought on the performance of the ACC Scheme, including the performance of individual Accounts and the merits and feasibility of competition in the delivery of workplace personal injury insurance, by 30 June 2010;
- 2 In developing its approach the Steering Group has taken account of the views it has received from some employers, trade union representatives, and insurance industry bodies, but has not tested its proposed approach with those or other stakeholders;
- 3 To assess merits and feasibility the Steering Group has defined competition to mean that competing private sector insurers would offer insurance cover to those required to purchase it, and the Group has assessed the merits and feasibility of this form of competition in general as well as in relation to the ACC Work Account;
- 4 To assess merits and feasibility the Steering Group has assumed that the status quo in respect of compulsion to purchase the level of cover, the level of benefits provided, and the prohibition on common law claims for negligence, would continue under competition;
- 5 The Steering Group has assumed that on the date when competition was introduced, all existing claims arising from the Work Account, and the associated reserves, would be separated from the competitive market and continue to be managed by the ACC;
- 6 In the period 2004 to 2009 the liabilities of the ACC increased by \$5.8 billion due to unanticipated increases in claims costs that were almost all within the control of ACC management. This increase in unfunded liability is unacceptable and, if it had been allowed to continue, would have undermined the financial viability of the ACC Scheme;
- 7 The Steering Group considers that the current structure of the ACC Scheme is fatally flawed, and that while elements of the current structure can be improved, only major structural change associated with the introduction of competitive private delivery can remove the risk of further unanticipated losses that is currently carried by levy payers and the Crown;
- 8 The Steering Group considers that **competitive private delivery of the ACC Scheme is necessary to:**
  - a achieve better financial performance and the improvements in rehabilitation rates that will necessarily underlie this improved performance;
  - b remove cross-subsidies and introduce stronger incentives for all New Zealanders to invest in reducing accident rates;

- c remove from future employers and other levy payers the risk that they will have to pay additional levies to make up for large amounts of unfunded liability incurred during past episodes for poor management of the ACC;
  - d remove from the Crown the risk of poor financial performance;
- 9 The Steering Group considers that **competition is feasible** because:
- a the personal injury cover provided by the Work, Earners' and Motor Vehicle Accounts is insurance, can be offered in a private insurance contract, and has a close relationship with other lines of insurance provided by the private sector in New Zealand;
  - b the insurance industry has substantial experience in pricing this type of insurance and in managing the long-term claims associated with incapacity;
  - c compulsory personal injury insurance is provided to employers by competing private insurers in many other jurisdictions, including in Europe and Australia and the US;
  - d the ongoing policy interests of government can be reflected in the ability to determine the statutory level of cover, require that the insurance industry creates a mechanism to provide cover to those who have not purchased insurance, monitor compliance with the statutory requirements and determine the nature of the prudential regulatory regime for insurers;
- 10 The Steering Group considers that **competition would have merit** because:
- a prices in the sector would better reflect injury risks so incentives for injury prevention and prompt rehabilitation would be stronger;
  - b private sector insurers will be required to set premiums that fully fund their liabilities, removing the potential for employers to be required to pay additional levies in respect of past unfunded liabilities;
  - c the additional costs of competing insurers (such as return on equity, marketing) would likely be offset by efficiency gains in pricing, claims management and bundling of statutory cover with other insurance cover;
  - d it is unlikely that the premiums charged by competitive insurers will be above the fully-funded premiums of the ACC, though premiums are likely to rise for high-risk activities and be reduced for firms with low risk and/or active injury prevention programmes;
  - e competition will better provide for diversity among levy payers and differences in the needs of specific groups within society;
  - f competition would remove financial risk from the Crown in respect of new insurance;

- 11 The Steering Group recommends that **if public monopoly provision of accident compensation in any Account is to continue**, the Minister for ACC:
- a reduces the high levels of cross-subsidisation between different groups of levy payers by introducing risk and experience rating consistent with the practices of the private insurance industry;
  - b requires the ACC to extend and improve the effectiveness of the Partnership Programme for accredited employers as a means of providing employers with incentives to invest in safer workplaces;
  - c requires that the ACC develops options that would allow a much wider range of organisations to participate in the delivery of accident compensation services, particularly those that can assist in providing more cost-effective services to different ethnic and socio-economic groups within the community;
  - d investigates the merits of extending the co-payment requirement associated with weekly compensation to all ACC benefits;
  - e requires that the ACC achieves a greater focus on improving return to work rates, and in particular, on raising return to work rates in the first three months following the accident. This should include setting targets for rehabilitation based on the best performance of the past, holding ACC management strictly accountable for the achievement of these targets, and the use of private sector support for rehabilitation and claims management wherever it is efficient to do so;
  - f implements all practical measures to reduce the 'entitlement culture' currently associated with ACC and return to a focus on rehabilitation and compensation of actual losses resulting from accidents by raising public awareness that the ACC Scheme is primarily a compulsory insurance scheme with social purposes and not a social insurance scheme;
  - g requires that the ACC management performance objectives are tightly linked to the key assumptions in the actuarial valuation as a means of minimising unanticipated increases in outstanding claims liabilities;
  - h improves the quality and timeliness of monitoring of ACC performance by ensuring that monitoring imposes a tighter link between measures of performance and the assumptions of the actuarial valuation, and is conducted with a focus on independent analysis and a culture of constructive challenge rather than acceptance of the information and frameworks for analysis provided by the ACC;
  - i reconstitutes the ACC as a State-Owned Enterprise with explicit equity capital and, to improve its accountability for the financial performance of the ACC, provides for the ACC Board to set levies subject to regulatory oversight;
  - j provides for time commitments and remuneration of Board members consistent with recognition that the ACC is the fifth largest financial institution in New Zealand;

- k considers mechanisms that will provide for higher levels of scrutiny of appointments to the ACC Board, consistent with the standards that would be set for large private sector financial institutions;
  - l sets levies at the level that will fully fund the expected value of the liabilities arising from new claims in the year for which the premiums are collected;
- 12 The Steering Group also recommends that:
- a there be no requirement for the ACC to change its investment policies, and in particular, no requirement to increase the ACC's investment in domestic equities;
  - b the Minister for ACC endorses the decision by the ACC Board to define full funding of claims liabilities to include a risk margin consistent with national and international reporting and regulatory standards;
- 13 The Steering Group recommends that, **if competitive private delivery for the Work Account is to be introduced:**
- a the ACC not compete in the market, but be focused on efficient management of the outstanding claims liabilities incurred up to the time when competition is introduced;
  - b the Minister for ACC commissions more detailed analysis of options for the implementation of competition including:
    - i whether to introduce competition for employees' non-work injuries (the Earners' Account) and personal injuries arising from use of motor vehicles (the Motor Vehicle Account) so that the problems created by regulatory boundaries between insurance for different types of accidents can be removed and private insurers can better serve levy payers with a full range of accident insurance services;
    - ii options for design of the market and the associated institutions, including the form of the statutory requirement for cover, the allowable extent of experience rating and self-insurance, and provision for residual insurance cover in the market.

# Preface

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## Minister's establishment of a Stocktake of ACC Accounts

- 1 In July 2009 the Minister for ACC announced a Stocktake of ACC Accounts, establishing an independent steering group and issuing terms of reference for the Stocktake. The terms of reference required the Steering Group to provide an interim progress report by 1 February 2010 and a final report by the end of June 2010. The terms of reference were updated by the Minister in October 2009 to include the investigation of the introduction of competition and choice into the Work Account. The terms of reference were also updated by a letter dated 11 December 2009 from the Minister for ACC requesting that the final report of the Steering Group explicitly consider the appropriateness of including a risk margin in the valuation of the liabilities of each ACC Account.
- 2 On 19 February 2010 the Chair of the Steering Group received a letter from the Minister for ACC that requested an additional interim report covering the merits and feasibility of introducing competition in the ACC Work Account and recommending a process for completing the detailed work on institutional and contractual design at the earliest possible time. This interim report was submitted on 16 April 2010.
- 3 This final report incorporates revised material from our interim reports.

## Process

- 4 Throughout the Stocktake we ensured that there was opportunity for key stakeholders to have input at appropriate junctures. We have met with Business New Zealand and the New Zealand Council of Trade Unions and a number of other organisations and individuals at various points of the Stocktake process, to keep them apprised of our approach and progress, and seek their views. Their views have helped to inform our work. In addition, we have reviewed their written submissions and these have been helpful for our deliberations.
- 5 We have received and reviewed a large amount of written information. This material came from a number of sources, including the ACC and the Stocktake secretariat (comprising officials from The Treasury and the Department of Labour).
- 6 In addition, the Steering Group commissioned work from independent third parties on the Māori experience of ACC, employer management of claims, monitoring of the ACC, funding policy, and comparisons with Australian workers' compensation schemes.
- 7 The Stocktake was not set up to seek and hear formal submissions; it was more an analytical exercise. However, various interested parties wrote unsolicited to the Steering Group or to the Minister for ACC with their views. These views were circulated to the Group.

- 8 In general, we have found the information from these interested parties useful. It has alerted us to several operational issues related to the ACC Scheme that have an impact on levy payers, employers, and claimants. In respect of our terms of reference, unsolicited information from submitters has guided us towards options for funding, and helped to identify potential risks to the ACC Scheme.

## Policy issues associated with New Zealand's accident compensation scheme

- 9 ACC is the Crown entity that manages New Zealand's universal, no-fault accident compensation scheme. The Scheme was established in 1974 following the 1967 Royal Commission of Inquiry by Sir Owen Woodhouse. The Woodhouse Report proposed that:<sup>1</sup>
- Injury arising from accident demands attack on three fronts. The most important is obviously prevention. Next in importance is the obligation to rehabilitate the injured. Thirdly there is the duty to compensate them for their losses.
- 10 The Woodhouse Report led to a radical extension of no-fault accident cover to include all injuries to workers (both for work and non-work injuries) and motor vehicle injuries through the ACC Scheme. In addition, the Scheme was extended to cover those not previously covered (including students, non-earners, and visitors to New Zealand).
- 11 The ACC Scheme is commonly viewed as creating a social contract whereby individuals give up their right to sue for compensatory damages in exchange for the benefit of comprehensive no-fault accident insurance cover and compensation. The Scheme provides statutory entitlements under the Accident Compensation Act 2001 (the Act). Section 3 of the Act states that, the purpose of this Scheme is to
- ... enhance the public good and reinforce the social contract represented by the first accident compensation scheme by providing for a fair and sustainable scheme for managing personal injury that has, as its overriding goals, minimising both the overall incidence of injury in the community, and the impact of injury on the community (including economic, social, and personal costs).
- 12 The Act sets out specific provisions for when an injury can receive cover:
- non work-related personal injuries, eg, injuries at home or while playing sport
  - motor vehicle injuries
  - work-related personal injuries
  - work-related gradual process injuries
  - work-related diseases or infections
  - sensitive (sexual abuse) claims
  - injuries that occur as a result of medical treatment.

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<sup>1</sup> page 19, paragraph 2 in Part 1 - Summary of the Report.

13 The Act sets out three core functions for the Scheme: injury prevention, rehabilitation, and compensation.

- **Injury Prevention:** ACC has a key role in promoting measures that reduce the incidence and severity of personal injury. However, the Act requires that such measures must be undertaken by the Corporation only if they are expected to lead to a cost-effective reduction in levy rates.
- **Rehabilitation:** the Act sets out specific provisions that prescribe what entitlements the injured person can access. Where a claim has cover, the ACC must provide entitlements to the level prescribed in the legislation with the goal of restoring an injured person's independence to the maximum extent practicable. ACC provides the following entitlements:
  - contributions towards the cost of treatment
  - social and vocational rehabilitation
  - associated ancillary services
  - purchase of aids and appliances to support rehabilitation.
- **Compensation:** the Scheme provides financial compensation to claimants for losses due to personal injury. The following forms of compensation are provided:
  - weekly compensation (earnings replacement) for earners, at 80% of earnings for workers who are injured and have not returned to work in a week
  - lump sum compensation for significant permanent impairment
  - accidental death benefits.

14 In recent years, the costs of delivering the Scheme have increased rapidly due to a number of factors. These include:

- new claim rates increasing faster than the underlying population growth
- rehabilitation performance rates declining, meaning claims have been open longer and cost more
- a larger than expected increase in the size of the long-term claims pool
- the impact of the global recession on investment returns and the present value of the outstanding claims liability
- increases in the scope of the Scheme due to legislative change and court decisions.

These trends threaten the long-term viability of the scheme. At the very least, significant increases in levies will be required to fund the increases in costs and liability.

15 The over-riding policy issue that has given rise to this review has therefore been the financial condition of the ACC Scheme, and in particular the rapid increase in its net liability (from \$3.38 billion at 30 June 2004 to \$12.75 billion at 30 June 2009) and the scale of the resulting increases in the levies required to fund it. However, it is also clear that these problems reflect a range of underlying policy issues, which include:

- i The limitations of the corporate form adopted for the Scheme and the business model used to operate it. ACC has no equity, its benefits are defined in statute, and its levies are set by Ministers. As a consequence the performance of the Scheme is difficult to assess and management accountability for Scheme performance is weak. Because it is a monopoly, there is no competitive pressure on the ACC aside from limited self-insurance and contracting out of claims management. This means that we have no direct test of whether the ACC is efficiently managed.
- ii The multiple objectives of the Scheme reflect disagreement and confusion about whether it is a provider of insurance services or part of the social welfare net. This confusion has resulted in different governments adopting markedly different positions on this issue over time, with the result that the stability of the Scheme has been undermined. The confusion is further reflected in the adoption of levy policies that create substantial cross-subsidies between the parties covered within each Account, provide employers, earners, and drivers with limited incentives to invest in mitigation of accident risk, and a weak alignment between the levies paid and the specific risks being covered. Thus the operation of and incentives provided by the Scheme are difficult to reconcile with the emphasis on the prevention of accidents that the Woodhouse Report proposed.
- iii Community expectations of entitlement to Scheme benefits that has the potential to surpass the ability and willingness of the community to pay the true (actuarially fair) cost of providing those benefits. This trend has been exacerbated by the opaque nature of the Scheme's funding arrangements.
- iv The entitlements provided by the Scheme are higher than those provided by the welfare system, and high compared to the actual future income-earning potential of many levy payers. These features reduce incentives to avoid accidents, increase incentives to represent incapacity as resulting from accidents, and reduce incentives for some recipients of benefits to return to work.
- v Different governments have varied in their commitment to actuarially fair full-funding of the liabilities of the Scheme, creating the potential for substantial inter-generational transfers of the cost of meeting existing claims and in the levies that are imposed.
- vi The impact of the Scheme on the Crown's financial performance is substantial, both directly in the Crown's capacity as a contributor to the Scheme and through the consolidation of the Scheme's operating position and balance sheet in the Crown's accounts, and indirectly through the Crown's implicit role as the guarantor of its liabilities.<sup>2</sup>
- vii The ACC Scheme also has a substantial private financial impact given the payment of levies by firms, earners, the self-employed, and owners of motor vehicles. It also therefore impacts on the society and economy of New Zealand, given the substantial

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<sup>2</sup> The claims expenses of the ACC Scheme amount to 4.5% of total government expenditure as at 30 June 2009.

amount of compensation provided to those injured by accidents. But many stakeholders have raised concerns about the efficiency of the Scheme which include:

- a the ability of a monopoly provider to implement efficient responses to the needs of different groups within society, including Māori
  - b the existence of substantial cross-subsidies between different risk pools within the Scheme
  - c the limitations on self-insurance options that provide enhanced incentives to efficiently manage workplace safety
  - d the inability of levy payers to purchase higher levels of cover or to efficiently bundle related or complementary insurance cover together with their ACC cover.
- viii Subsequent sections of this report provide a basis for understanding how these policy issues have arisen and are integral to the current structure of the ACC Scheme, the failure to apply appropriate insurance principles to its operation, the lack of clarity in the objectives and governance of the Scheme, and the culture that has developed around a monopoly public sector provider of services. We have undertaken a comprehensive review of the Scheme because there may be some policy problems that the introduction of competition alone cannot solve. In addition, at least some of the policy problems of the ACC Scheme may be addressed in ways that do not require the introduction of competition.

## Outline of the report

- 16 This report is structured into three parts. Part A considers the origins and nature of the ACC Scheme, its performance, and the options available to improve that performance. The options considered are those that are consistent with retention of public monopoly provision of the ACC Scheme.
- 17 Part B considers the merits and feasibility of competitive private delivery of the ACC Scheme. In particular, it provides an analysis of whether the performance problems that have characterised the ACC Scheme throughout its history could be addressed by the introduction of competitive private delivery, and an analysis of the opportunities for improved performance that competition would provide.
- 18 In Part C of this report we provide our conclusions.
- 19 Appendix 1 provides a summary of the experience with competing private delivery of accident compensation cover in other jurisdictions. In addition to providing an outline of the range of different jurisdictions around the world using competitive delivery for similar types of compulsory accident insurance, we provide a more detailed assessment of the experience of competing private delivery in Australia and in Europe.

# Part A: The Nature and Performance of the ACC Scheme

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## 1 Introduction to Part A

- 20 The terms of reference for the Stocktake of ACC Accounts (see Appendix 4) direct the Steering Group to undertake a comprehensive analysis of the current ACC Scheme and the performance of the ACC as the public monopoly provider of accident compensation services. We have interpreted this direction as requiring that we examine the origins, rationale, structure, and performance of both the ACC Scheme and the Corporation as the monopoly public provider of accident compensation benefits. In addition we consider changes that may lead to improved performance of the Scheme, but here in Part 1 we primarily confine ourselves to considering the changes consistent with continuation of the current structure of public monopoly provision.
- 21 Following this Introduction to Part A, section 2 begins with a survey of the origins of New Zealand's accident compensation scheme, the principles on which it was established and their relevance to the 21st century, and the current structure of the Scheme. Section 3 then provides a detailed examination of the ways in which the Scheme may be defined, its boundaries with the social welfare system and the private insurance industry, and the relevance of insurance concepts to the Scheme.
- 22 Section 4 considers the funding of the Scheme, including its current levy structure, the actuarial basis on which required levies are determined, and the debates about full funding of the Scheme and the use of a risk margin in the determination of the level of funding required. This section also contains a review of investment management and performance at the ACC.
- 23 Section 5 considers the performance of the ACC from the perspective of claims cost and rehabilitation rates. We examine the performance of the Scheme overall, the factors that have contributed to the recent increase in the unfunded portion of the outstanding claims liability, and the performance of the individual Accounts.
- 24 Section 6 considers the impact of the Scheme on Māori, both from the perspective of Māori utilisation of the Scheme, and through survey information on Māori views about the quality and effectiveness of the Scheme and ACC service delivery to Māori, and the potential for the introduction of greater choice in the delivery of the accident compensation scheme.
- 25 Section 7 considers the governance, regulation and monitoring of the ACC. We assess these aspects of the structure and performance of the ACC against a number of criteria for good governance, including the identification of clear and consistent organisational objectives, the expertise and experience of Board members, the incentives and

accountability of Board members and senior executives, and mechanisms for monitoring Board and management performance.

- 26 Section 8 examines a range of ways in which the financial performance, value for money, and efficiency of the ACC Scheme could be improved. The focus of this section is on options for changes to the current structure of levies and benefits.
- 27 Section 9 sets out our conclusions on the performance of the ACC, and the ways in which it could be improved if the current structure of monopoly delivery were to be retained.

## 2 The origins of New Zealand's accident compensation scheme

### Introduction

28 In this section we set out the origins of the current accident compensation scheme in New Zealand. We provide a brief description of the legal framework relating to accident compensation in the 1960s, which provided the background to the report of the *Royal Commission of Inquiry into Compensation for Personal Injury* (1967) (hereafter, the Woodhouse Report). We consider the principles laid out in the Woodhouse Report, and the way in which they have translated into the modern structure of the ACC Scheme.

### Accident compensation in the period before the Woodhouse Report

- 29 During the 1960s the legal framework for compensating personal injury in New Zealand had the following features:
- common law action for damages where personal injury could be attributed to negligence
  - where negligence was not present or common law action not pursued, compensation for work-related accidents on a “no fault” basis funded by compulsory insurance for employers under the Workers’ Compensation Act 1956
  - payment of welfare benefits at a subsistence level to persons who could satisfy the prescribed means test under the Social Security Act 1964
  - compensation to the victims of the offences described in the Criminal Injuries Compensation Act 1963 based on actual medical, funeral, and pecuniary expenses and the pecuniary loss from incapacity of the victim
  - compensation for damages sustained in motor vehicle crashes where a third party was at fault, funded through a compulsory levy on owners of motor vehicles and a ‘Third Party Pool’ insuring the victims of those who avoided paying the levy, under the Transport Act 1962.
- 30 Private insurers played a central role in this compensation system, as providers of discretionary insurance to employers and individuals, and as providers of compulsory insurance to employers who did not meet the requirements for self-insurance following the introduction of mandated insurance cover in the Workers’ Compensation Act 1943. In 1967 the compulsory workers’ compensation insurance was being provided by 61 private insurers (including mutual companies), 48 self-insurers, and the State Insurance Office.<sup>3</sup>
- 31 This framework for compensation was the subject of widespread contemporary criticism from different perspectives. Some lawyers and union representatives criticised the high cost of bringing common law claims and the uncertainty of the outcomes associated with

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<sup>3</sup> Royal Commission of Inquiry into Compensation for Personal Injury (1967) p.180.

them. There was criticism of the level of compensation obtained by those who could not establish common law claims, and of claimed anomalies in the classification of injuries set out in the schedule to the Acts. There was also criticism of the role of private insurers in the system, both for the assertion that large portions of the premiums were retained for administrative expenses and profit, and that statutory compulsion to purchase insurance had commuted workers' compensation insurance into a type of 'social insurance'. The latter concern resulted in a brief period of state monopoly delivery of the insurance by the State Insurance Office from 1949-1951. But this experiment was abandoned when it became clear that, given the strong economies of scope between workers' compensation insurance and other lines of insurance, this monopoly conveyed to the State Insurance Office an extreme competitive advantage in the writing of a wide range of other insurance products.

## The Woodhouse Report

- 32 The Woodhouse Report articulated some of the most stringent contemporary criticisms, describing common law legal action as "a form of lottery", attacked the meagre nature of compensation provided as of right, and described the overall legal framework as providing a "fragmented and capricious response to a social problem which cries out for co-ordinated and comprehensive treatment".<sup>4</sup>
- 33 As an alternative, the Woodhouse Report described five principles on which the New Zealand accident compensation scheme should be based:<sup>5</sup>
- **Community Responsibility:** because society benefits from the productive work of its citizens, so it should accept responsibility for, and share on an equitable basis in sustaining, those willing to work but prevented from doing so by physical incapacity.
  - **Comprehensive Entitlement:** consistent compensation awards for incapacities sustained by each class of worker.
  - **Complete Rehabilitation:** to encourage every injured worker to recover the maximum degree of bodily health and vocational utility in a minimum of time.
  - **Real Compensation:** adequate recompense for a realistic assessment of actual loss, both physical and economic, unrestricted by tests of need.
  - **Administrative Efficiency:** the collection of funds and their distribution as benefits should be handled speedily, consistently, economically, and without contention.
- 34 The principles enunciated in the Woodhouse Report are drawn very widely. Considering the importance that has been placed upon them in past interpretations of the ACC Scheme, and the support that they have elicited from a wide range of quarters, it is notable that they fail to address a number of key issues of interpretation. First, the

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4 Royal Commission of Inquiry into Compensation for Personal Injury (1967) p.19

5 Ibid pages 39-41.

principles could apply with equal force to incapacity resulting from illness because they offer no conceptual rationale for differential treatment of incapacity arising from illness. Second, they offer limited assistance in determining whether the Scheme should be viewed and operated primarily as a social welfare scheme that provides compensation related to income rather than having standard minimum benefit levels, or as a publicly mandated insurance scheme that requires all New Zealanders to pay levies to meet the cost of benefits that are substantially above those that any welfare scheme is likely to provide. Third, they do not provide an explicit rationale for public monopoly delivery of the Scheme, or for exclusion of private sector participation. We return to these fundamental issues about the definition and boundaries of the ACC in section 3 below.

## Current structure and coverage of the ACC Scheme

35 The structure and scope of the ACC Scheme is set out in the following table.

ACC Account	Coverage	Funding
<b>Work Account</b>	All work-related injuries	Levies paid by employers and the self-employed
<b>Non-Earners' Account</b>	Injuries to people not in the paid workforce	The Crown (sole levy payer)
<b>Earners' Account</b>	Non-work injuries to earners	Earners' levies (paid through PAYE), plus levies on earnings of the self-employed
<b>Motor Vehicle Account</b>	All personal injuries involving motor vehicles on public roads	Petrol excise duty and a levy collected with the motor vehicle license fee
<b>Treatment Injury Account</b>	Injuries arising from medical treatment	Earners' and Non-Earners' Accounts
<b>Residual Claims Account (now part of the Work Account)</b>	The continuing cost of work-related injuries sustained before 1 July 1999 and non-work injuries to earners before 1 July 1992	Levies paid by employers and the self-employed

36 The entitlements provided by the ACC Scheme and the Accounts to which they apply are set out in the following table.

Entitlement	Accounts
Weekly compensation	Earners either under the Work, Earners', Motor Vehicle or Treatment Injury Accounts. Long-term claimants
Loss of potential earning weekly compensation	Potential earners <sup>6</sup> mostly paid from the Non-Earners' and Motor Vehicle Accounts
Lump sum payments or Independence Allowance.	All Accounts – every claimant is eligible if assessed as having a minimum 10% impairment. May be awarded to the dependants of a deceased claimants
Social rehabilitation Includes home and community support services (attendant care, home help and child care), aids and appliances, education support, modifications to the home, training for independence, transport for independence (car retro-fits as well as other transport) and other services that ACC may think are necessary.	All Accounts but most costs are related to long-term serious injury claimants. The Motor Vehicle Account has more serious injury claimants than other Accounts but the Treatment Injury Account has a number of birth injury claimants, which means the ongoing claims liability is high.
Vocational rehabilitation Includes costs of occupational and medical assessments as well as return to work courses and assistance. Rarely includes retraining.	Work Account, Earners' Account, potential earners, earners from the Motor Vehicle and Treatment Injury Accounts.
Medical treatment includes medication, transport to treatment and accommodation necessary to receive treatment. Including elective surgery (although this could be regarded as rehabilitation)	All claimants in all Accounts with an assessed need.
Entitlements for fatal injuries (includes funeral grant, survivor's grant and weekly compensation if the deceased was an earner). In this instance weekly compensation is time-limited depending on the age of children or to 5 years if there is a dependent partner.	The dependants of all deceased claimants receive the funeral grant and survivor's grant. The dependants of deceased claimants who were working at the time of death receive weekly compensation under the Work, Earners', Motor Vehicle, and Treatment Injury Accounts.

37 The ACC Scheme forms a substantial part of New Zealand's insurance, social welfare, and healthcare environment, and provides benefits of some kind to a high proportion of New Zealanders each year. But the Scheme faces important challenges, among the most important of which are the rising cost of the Scheme over time, resulting from:

- Scheme immaturity – the Scheme is yet to reach maturity, which means that more new claims enter the Scheme each year than are settled. Until the Scheme matures the claims population will continue to grow.
- increasing costs per claim – the average cost per claim is rising due to advances and increases in the cost of healthcare, increased claims duration, legislative change, and additional claimant support.

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<sup>6</sup> A potential earner is a claimant who is injured and is incapacitated before they enter the workforce. Weekly compensation at the Loss of Potential Earnings rate is payable once a potential earner reaches age 18, has been incapacitated for at least 6 months, and is not in full-time study.

- an ageing population – this leads to an increase in co-morbidities such as diabetes, obesity, and osteoarthritis. The number of claimants who present with a pre-existing condition is increasing, making the management of their rehabilitation lengthier and more complex.
- coverage and entitlements – the scope of what is covered by the Scheme has changed as a result of legislative change and court decisions that alter the way the legislation is interpreted. Recent additions to the Scheme include work-related mental injury, twisting injuries, expansion of treatment injury, and new occupational diseases. Furthermore, legal decisions such as the decision to award back-dated attendant care and to extend vocational rehabilitation for those aged over 65, have resulted in expansion of entitlements.
- changes in the culture of the scheme – in particular the emergence of a culture of entitlement to ACC benefits which has resulted in slower rates of return to work and a growth in the number of long-term claimants .

38 If costs rise too quickly, they may represent not just a threat to the financial stability of the Scheme but a threat to the continuation of the Scheme itself.

39 Since the Woodhouse Report was released in 1967 there have been no fewer than four major reviews of the ACC Scheme, usually following a financial crisis. These include:

- the 1979 Quigley Committee review, which led to the changes embodied in the 1982 Accident Compensation Act
- the 1986-1987 Officials Committee review, which in turn led to the Law Commission review of 1988
- the 1991 Officials' Working Party review, which led to the changes embodied in the 1992 Accident Rehabilitation and Compensation Insurance Act.
- the extensive reviews of the Scheme undertaken in the late 1990s in advance of the introduction of competition to the Work Account in 1999

This Stocktake may therefore be viewed as the latest in a now established series of reviews commissioned in response to major performance problems with the ACC Scheme.

## Conclusion

40 The Woodhouse Report's conception of a compulsory no-fault scheme providing compensation based on actual losses for all victims of accidents in New Zealand is rightly regarded as a major contribution to public policy in New Zealand. The scheme proposed by the Report was a response to the perceived inequities in compensation provided to injured workers, and perceived procedural inefficiency in legal claims for negligence, that were part of the workers' compensation system of the 1960s.

41 The Woodhouse Report did not give detailed consideration to three issues: the complexities that would arise from a scheme that provided differing responses to incapacity arising from illness and incapacity arising from accidents, the need to distinguish

between an insurance scheme with social purposes and a social welfare scheme, and the rationale for public monopoly delivery of the scheme. These structural issues have been considered in past reviews arising from unsatisfactory performance of the ACC Scheme, but never clearly resolved.

### 3 Boundary issues: defining the nature of the ACC Scheme

#### Introduction

- 42 Understanding the ACC Scheme requires clarity on a number of boundary and definition issues include the following:
- The Scheme could be interpreted as either, or both, a social welfare a scheme that provides compensation related to income rather than standard minimum benefit levels, or a publicly mandated insurance scheme that requires all New Zealanders to pay levies to meet the cost of benefits that are substantially above social welfare levels.
  - The Scheme draws a distinction between losses and treatment arising from accidental causes and those arising from ill-health.
  - To the extent that the Scheme provides insurance, it is anomalous that the ACC is precluded from offering compensation on losses from non-accidental causes, and private insurers underwrite policies in the space defined by non-accidental causes of medical treatment or loss of income.
- 43 In this section we explore these boundary issues in the ACC Scheme as a means of establishing a basis for the interpretation and analysis that follows. We begin by examining the views of the Woodhouse Report on the positioning of the ACC at the boundary between insurance and social welfare. We then consider definitions of social welfare and insurance, and provide an analysis of the ACC Scheme against standard definitions of insurance. Finally, we consider aspects of the boundary between the ACC and the health and social welfare systems.

#### The Woodhouse Report and the Law Commission on social welfare and insurance

- 44 Perhaps the most confusing sections of the Woodhouse Report relate to the question of whether the scheme proposed in the Report was a compulsory insurance scheme or a social welfare scheme. Below we attempt to explain the source of the confusion.
- 45 The Woodhouse Report contains clear evidence that its authors recognised that the scheme being proposed was a form of insurance:
- The compensation purpose of the scheme is not to provide merely for need but to shift a fair share of the burden suddenly falling upon individuals as a result of injury. This is a form of social insurance – not a form of social assistance.<sup>7</sup>
- 46 However, the authors of the Woodhouse Report were also very critical of the involvement of private insurers in the workers' compensation arrangements of the 1960s and took the view that a no-fault system of the type that they were recommending was incompatible

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7 Paragraph 107 at p.279.

with the role that they observed private insurers taking in the system that preceded it. In making the case to exclude insurers from involvement in the new system, the Woodhouse Report claimed that:

... this is not an insurance scheme at all. It has always been treated as such in New Zealand, but in truth it is a compulsory and universal method of sharing one of the costs of social activity. The interpolation of private enterprise between the group of beneficiaries and the ordained fund has arisen simply because the contributions to the fund have been required and collected, not in the form of tax from employers as a general class, but as individuals and in terms of individual risks.<sup>8</sup>

- 47 As the New Zealand Law Commission (1988) later summarised the overall ethos of the Woodhouse Report, it was to recognise that the compulsory private insurance framework of the 1960s was a social insurance scheme which only by “a legislative accident had [private insurers] attempting to act as society’s agents for collecting disguised taxes in the form of premiums”. The aim of the Woodhouse Report had been to remove any confusion that accident compensation was insurance offering cover against the risk of future losses, and that it could be entangled with “the business purposes and economic goals of the private sector”. From this perspective the Law Commission concluded that:

This scheme is not in any sense an insurance system. Its benefits are provided as of right without reference to cause and regardless of risk. It is simply one component of the general social welfare provisions of the country.<sup>9</sup>

- 48 In a subsequent section of their report the Law Commission wrote :

The system in its present conception is not an insurance scheme any more than other parts of our social welfare system. Now we do not deny that accident costs could be met by private insurance – that after all happens at the moment in respect of property damage and supplementary personal injury schemes. But a wholesale move to a system of private insurance would involve a rejection of the underlying principles and essence of the scheme.<sup>10</sup>

- 49 The Steering Group has considered the Law Commission’s assertion that the accident compensation scheme created following the recommendations of the Woodhouse Report is a part of our social welfare system, and thus not insurance. In our view, this characterisation of the ACC Scheme is unhelpful in the following three respects.

- It is tautological: that is, it is based on the claim that because certain parties choose to call it a scheme of social welfare it cannot be insurance or offered by the insurance industry. The difficulty with a tautology is that it assumes what it purports to establish and thereby provides no assistance in assessing the more fundamental issues. In addition, a comprehensive rejection of any role for private enterprise in the delivery of social welfare is inconsistent with modern views of the potential synergies between social purposes and private sector capital and expertise.

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8 Ibid page 88.

9 Law Commission (1988) page x

10 Law Commission (1988) p.72

- In declaring it to be a social welfare scheme the proponents of this approach failed to address conceptual difficulties such as the inequitable treatment of costs and loss of income from sickness, including the provision of income-related benefits rather than the much lower levels of income support associated with incapacity through sickness.
- Key elements of the social welfare approach recommended by the Woodhouse Report and the Law Commission have either been explicitly or implicitly rejected. Thus, a separation has always been maintained between the Work, Earners', Non-Earners', Motor Vehicle, and Treatment Injury Accounts for the reporting of income, claims, and long-term liabilities.<sup>11</sup> In addition, despite state monopoly delivery, where viable alternatives to the funding of the ACC Scheme from general taxation revenue have been available, these have been utilised (including having a specific levy for the Earners' Account rather than bundling the funding in with general taxation revenue that funds health, unemployment, and superannuation benefits). As well, some levies paid have been differentiated based on risk (including revenue from petrol sales as a proxy for vehicle use) and risk and experience rating of premiums (eg employers and motorcycles).

Thus, the Woodhouse Report's recommendation that accident compensation should be provided purely as a type of social welfare has been recognised as inefficient, inequitable, and ultimately impractical even under state monopoly provision.

50 The recognition of the Woodhouse Report and the Law Commission that the ACC Scheme is or could be a type of insurance, while at the same time they were adamant that it must be managed as a social welfare scheme, can most readily be explained by:

- their desire to ensure that private insurers did not reintroduce uncertainty about the ability to receive compensation that existed under the contested and fault-based system preceding the ACC Scheme. The authors of the Woodhouse Report appear to have viewed private insurers as central to the operation of the Workers' Compensation Act, and their exclusion from the ACC Scheme as crucial for a successful transition to a no-fault scheme with guaranteed benefit levels.
- Their desire to rule out differentials in levies based on risks covered and variations in the frequency with which accidents occurred in different industries. The authors of the Woodhouse Report appear to have been concerned with the potential for levies, especially levies based on risk and experience rating, to promote confusion between the social purposes of the ACC Scheme and the fault-based private insurance model that was represented by the Workers' Compensation Act.

51 Below we set out a more systematic assessment of the defining features of social welfare and insurance, and the extent to which the ACC scheme represents insurance risks.

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<sup>11</sup> The Law Commission noted that implementation of the social welfare approach would require that since the benefits provided were identical, the distinction between the funding and liabilities of different Accounts was unhelpful and should be abandoned lest it invite comparisons with a scheme of insurance [p.69 para 225].

## Social welfare or insurance?

52 At the heart of considerations about the performance and efficiency of the ACC is the question of whether it is most usefully viewed as an insurance or a social welfare scheme. There are six important factors that underlie the distinction between social welfare and insurance.

- **Ex ante vs. ex post redistribution:** Insurance contracts set premiums that fairly reflect the likelihood of the occurrence of the contingency against which the insurance is purchased. In this sense there is no *ex ante* redistribution of wealth implied by an insurance contract. Insurance contracts provide for redistribution of wealth among individuals, but only *ex post facto*, and only on the basis of the (more or less random) occurrence of the contingency insured against. Social welfare schemes, in contrast, are designed to achieve *ex ante* redistribution; that is, they are partly or wholly designed to redistribute income from one group in the population to another on the basis of characteristics that are observable *ex ante*. For example, the social welfare system may redistribute income from rich to poor, changing the expected income stream of individuals.
- **Compulsory vs. voluntary participation:** A key element of social welfare schemes is that they are compulsory. This is because the *ex ante* nature of the redistribution that occurs in social welfare schemes means that individuals who expect to be net contributors to the scheme may not participate voluntarily, whereas all those who expect to be net beneficiaries will. Compulsory participation is, however, a necessary but not sufficient condition for the identification of social welfare. Insurance is often purchased voluntarily, but there may also be market or institutional failures (such as those resulting from people free-riding on the social welfare net or externalities for third parties) that may make it desirable for governments to legislate for mandatory insurance coverage.<sup>12</sup> Such compulsion does not, in itself, transmute insurance into social welfare, nor does it suggest that private underwriting and delivery of the insurance is inefficient.
- **Choice:** Insurance schemes provide not only a choice around whether or not to participate, but also provide choice about the nature of the benefits purchased. High income individuals may choose to pay higher premiums to obtain higher benefits, and other individuals may choose higher co-payment provisions to reduce the premiums that they must pay for each level of insurance. In contrast, social welfare systems rarely provide choice of this type. Social welfare benefits are generally in a standard form, and universally applicable except in situations where income or asset tests make the benefits unavailable to those who are assessed as not requiring the support provided by the welfare benefits.
- **Funding:** Social welfare is generally funded from taxation rather than premiums, because premiums will not be paid voluntarily when there is explicit redistribution of wealth. Funding a scheme through taxes based on income ensures that high income

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<sup>12</sup> The relative efficiency of different taxes is relevant to this issue, and we discuss this below.

individuals contribute more in premiums, even though all individuals receive benefit levels that are the same or only based on income and premiums to a limited extent. In contrast, insurance contracts offer variable benefit levels that are tightly linked to the magnitude of the premiums paid, thus avoiding *ex ante* redistribution except that associated with efficient pooling.

- **Incentive design:** A key component of insurance contracts is the design of incentive-compatible premium and payment schedules that address the moral hazard and adverse selection problems pervasive in insurance markets. Some common elements of insurance contracts attempting to address these problems include use of deductibles, co-insurance, and experience rating. Social welfare schemes, in contrast, use compulsory participation as a means of addressing the extreme adverse selection associated with *ex ante* redistribution and the presence of other welfare programmes. Relatively low benefit levels and monitoring serve as blunt instruments for controlling moral hazard. Social welfare schemes will be most appropriate in markets where the type and magnitude of the adverse selection problem requires compulsory coverage, and where the moral hazard associated with the provision of benefits is small relative to the social costs arising from the contingency covered by the scheme. For example, the rate of unemployment in the population as a whole varies across the business cycle in a manner that is unrelated to the effort and actions of individual workers, and therefore, if the social costs (for example poverty and crime) associated with widespread unemployment are high, social welfare may be more appropriate than private provision of insurance in this case.
- **Recompense for losses vs minimum acceptable living standards:** Social welfare schemes normally provide minimum levels of support regardless of past income, whereas the ACC Scheme provides income-related benefits based on the concept of recompense for losses incurred as a result of an injury. This means that the ACC is designed to address the opportunity cost of injury not the maintenance of minimum socially acceptable standards of living, and as such the benefits provided by the ACC are at much higher levels than social welfare programmes.

53 In practice, many problems will contain elements of both social welfare and insurance. Where the insurance component is large, as it certainly is in the market for accident insurance, then the social welfare elements of the problem may be dealt with in full by making the purchase of some minimum level of insurance benefits mandatory or placing reliance on a safety net.

## Compulsion and cross-subsidies

54 Social welfare schemes are compulsory and provide universal coverage as a result. Compulsion is necessary because the *ex ante* nature of the redistribution of wealth associated with social welfare means that in the absence of compulsion only those individuals who expect to be net beneficiaries of the scheme will contribute voluntarily.

But compulsory participation is not a sufficient condition for establishing a distinction between social welfare and insurance.

- 55 At present each of the ACC Accounts contains some explicit elements of cross-subsidy that introduce elements of “social welfare” to the Scheme. This cross-subsidisation arises because of the limitations on the use of, and premium differentiation between, risk pools and experience rating (which has only been reintroduced in 2010). It also arises because of the payment from general taxation of premiums for the Non-Earners’ Account. In addition, participation in all of the ACC Accounts is compulsory.
- 56 In the Work and Earners’ Accounts cross-subsidies arise from limitations on experience rating of premiums. For the Motor Vehicle Account cross-subsidies arise from the absence of the level of premium differentiation that the private sector would apply to collision insurance. And for the Non-Earners’ Account cross-subsidies occur because of the payment of the premiums from general taxation. But even in the case of the Non-Earners’ Account it is appropriate to discuss having actuarially fair premiums for the accident insurance obtained by the insured parties. The break with the pure insurance model arises because the selection and incentive effects associated with the setting of actuarially fair premiums will be obscured by the payment mechanism (from general taxation).
- 57 These elements of cross-subsidy result from political choices to introduce cross-subsidies into the management of a state monopoly accident insurance scheme, and do nothing to undermine the view that it is insurance that is being provided. Indeed, from this perspective, a key element of support for state monopoly provision arises from the ease with which it provides politically-motivated cross-subsidies and the greater complexity that would arise in imposing such cross-subsidies should the insurance be provided by competing private insurance companies.
- 58 The problem with the introduction of cross-subsidies is that they reduce the efficiency of the insurance that is a core component of the ACC Scheme. Cross-subsidies reduce the scope for the definition of appropriate risk pools and the setting of actuarially fair premiums associated with them. It is therefore our view that if the government wishes to provide subsidies to particular families or individuals, it should do so through the explicit social welfare mechanisms already available.
- 59 Insurance may be purchased voluntarily, but there may also be market or institutional failures (such as those relating to adverse selection or externalities for third parties) that may make it desirable for governments to legislate mandatory insurance coverage. Compulsory purchase of cover does not change the nature of the insurance – compulsion may be interpreted as either prudential or anti-free riding. Compulsory purchase of insurance is also a feature of the group insurance schemes that are a standard feature of private sector insurance. Group insurance is a type of compulsory insurance negotiated for all members of an organisation or employees of a firm. Thus, in our view it is

appropriate to analyse current accident compensation insurance in New Zealand as a type of group insurance organised by the government. Such compulsion in itself does not commute insurance into social welfare, nor does it suggest that private underwriting and delivery of the insurance is inefficient.

## Insurance

- 60 Uncertainty is a fundamental feature of life because individuals are unable to predict the timing and magnitude of events that may have a profound effect on their wellbeing. Insurance may be broadly defined to include all the actions people undertake to mitigate the effects of uncertainty. Modifications of individual behaviour may reduce uncertainty but since there are many events that occur with a frequency that is unrelated to the behaviour of each individual, insurance contracts provide a vehicle by which uncertainty about outcomes for each individual is transferred (pooled) and the costs of uncertainty are spread across a large group of individuals.
- 61 The essence of the insurance contract is the payment of a premium by the insured in return for a promise from the insurer to pay a certain sum in the event that the contingency insured against actually occurs within the contract period. Insurance companies commonly also provide services following the occurrence of a claim, including the payment of claims, the provision of health and rehabilitation benefits, etc. but it is the provision of the insurance against the contingency, rather than the provision of services associated with the claim, which is the fundamental and unique feature of the insurance industry. This is seen most clearly in the case of an insured party who does not claim on the policy; this party has benefited from the transfer of risk arising from the insurance even though there has been no claim made.
- 62 The benefits of an insurance contract are derived from two elements of insurance: the transfer of risk and the pooling of risk. The individual policyholder transfers the risk, in that a loss is payable by the insurer. The individual policyholder shares in the risk borne by other policyholders in that each policyholder contributes, through the premium paid in advance, to the cost of meeting the claims of the policyholders as a whole.
- 63 Policyholders pay a premium sufficient to cover the cost of claims, management expenses, and return on capital to the insurance company because of the benefit that they obtain in being insured against the small but non-zero probability of the occurrence of some contingency that may impose high or catastrophic financial costs on the individual policyholder. Because policyholders are risk averse by definition, they will be willing to pay individual premiums that are in excess of the expected payout for the population as a whole, and this margin funds the costs of the insurance company. The insurance company is willing to assume the risk of providing insurance because its investors are less risk-averse than its policyholders and because, in a large sample of more or less independent and identical risks, the claims payable each period are much more predictable than they

are for the individual policyholder. In other words, insurance company operations are built on the principle that outcomes for a large sample of policyholders are predictable whereas for the individual they are not.<sup>13</sup>

- 64 The capital or shareholder equity in an insurance company is of significance for two reasons:
- the pattern of claims in any given period is still somewhat unpredictable, and thus the premiums levied in any period may or may not be sufficient to cover the claims from that period
  - the reserves for ongoing payments in respect of past claims are estimates, and the actual costs may vary from these estimates.
- 65 In both cases shareholder equity provides the assurance that the insurance company will be able to meet its claims liabilities should the pattern of claims or the cost of past claims be higher than the expectations on which premiums were set. The uncertainty associated with the claims experience of insurance companies may also be mitigated by re-insurance (the transfer of some portion of the risk associated with the insurer's business to a third party insurer) as well as by the use of insurance futures and options.<sup>14</sup>

## Insurance and asymmetric information

- 66 A standard feature of insurance markets is the presence of asymmetric information: in particular, that the insured party has more information relevant to the insurance contract than the insurer. It is not possible for insurance companies to obtain full information about the insured party, or to write a contract that includes provisions addressing all potentially risk-enhancing actions that the insured party might take. The theory of insurance distinguishes between adverse selection (information known only to the insured party before the contract is written) and moral hazard (actions taken by the insured party after the contract is written). Adverse selection means that because the insured party has more information about the likelihood that the contingency insured against will occur, insurance will be most attractive to those in high risk categories whereas those with low risk may self-insure by not taking out insurance with a third party insurer. Moral hazard means that once the insurance contract is written the probability of a claim for the contingency insured against is increased. Moral hazard recognises the incentives that provide both:
- the potential for changes in behaviour that will increase the risk for the insured party
  - the potential for loss of good faith that may result in opportunistic claims against the insurer for events that fall outside the insurance cover.

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<sup>13</sup> In the theory of statistics this is known as the law of large numbers.

<sup>14</sup> For this reason the adequacy of the capital of insurance companies is normally assessed against the premiums written net of reinsurance.

- 67 Private sector insurers address the problems created by adverse selection and moral hazard through a range of mechanisms that include:
- adjusting premiums based on both observable characteristics of the insured party *ex ante*, and the frequency with which claims are made (experience rating and no-claims discounts)
  - the sharing of the loss between the insurer and the insured party (co-insurance) through deductibles and limitations on the total value insured
  - restrictive covenants in contracts that make the insurance void in specified cases of moral hazard and adverse selection (such as self-injury and failure to disclose relevant information)
  - accident prevention and information sharing programmes designed to promote low-risk behaviour in certain circumstances.
- 68 The adjustment of premiums on the basis of observed characteristics involves what is known as establishing risk pools. The propensity of young male drivers to have motor vehicle crashes is a standard example. Some characteristics are easily observed, and others are not. One common feature of insurance is that the propensity for claims and the proclivity for risk-taking by the insured party may be correlated across different types of insurance. Thus, insurers offer discounts for the purchase of multiple lines of insurance reflecting both the greater information available to the insurer about the insured party from the ability to observe their actions in relation to multiple types of insurance cover, and the spreading of fixed administrative costs across several policies. For example, the combination of income replacement, accident, and health insurance may be more efficient than the offer of insurance for these contingencies on an individual basis because of common elements in the occurrence of these events (for example, ill-health may result in the loss of employment).
- 69 The sharing of the loss between the insured party and the insurer is a common feature of insurance because of the extreme incentive problems that may arise. There is also extreme differentiation of incentive effects among different types of workers. Workers who do not expect to be promoted in the future may find it attractive to cease work if they can then receive an ongoing income of 80% of their current income, whereas for workers who expect to be promoted in the future to accept 80% of their current income might involve a very substantial sacrifice over the income that they expect to earn in five years' time. Therefore, where insurance companies can identify workers who have more limited prospects for future promotion they may reasonably require higher levels of co-insurance than they would for workers with strong professional qualifications or long-term career prospects.
- 70 A very clear example provided by the current institutional arrangements in New Zealand is that individuals covered by ACC but who have not taken out private health and income replacement insurance have very strong incentives to claim that any ailment affecting

them results from an accident so that they can obtain the higher level of benefits provided by ACC (particularly income replacement for time off work). The potential is increased because the distinction between accidental and other causes of impairment may be on any estimation far from clear cut.

## Insurance and transaction costs

- 71 Efficiency in the provision of insurance requires that transaction costs be minimised in the design of insurance contracts. A key issue with the creation of a statutory scheme such as the ACC Scheme, and the absolute regulatory separation between the accident insurance provided by the Scheme and other lines of insurance, is that it will increase transaction costs and reduce efficiency in a number of ways. For example:
- a standard feature of private insurance contracts is that they offer the insured party a menu of options that provide different premium payments for different levels of co-insurance. The insured party will normally be willing to bear some risk associated with any contingency insured against, and one obvious way to do this would be to trade off a lower premium in return for self-insurance for small claims (such as a visit to the GP).
  - artificial distinctions between different types of insurance, such as are created by regulatory boundaries between the offer of insurance for loss of income from accidental causes and the offer of insurance for loss of income from all other causes increase the transaction costs associated with obtaining insurance against loss of income from all causes.
  - statutory limits on the level of cover required, particularly caps on total weekly compensation benefits in the ACC Scheme, require separate contracts to be written with a different insurer if the insured party wants a higher level of coverage.
- 72 Each of these examples suggests that there are substantial increases in transaction costs and losses in efficiency resulting from the combination of regulatory separation of a compulsory accident insurance market and the exclusion of insurers offering cover from all other related forms of risk from that market.

## ACC and private insurers compared

- 73 The Steering Group requested a paper from the ACC, with input from Treasury and the Department of Labour, on the similarities and differences between ACC and private insurers. This section summarises the views provided in that report and outlines our conclusions.
- 74 Some differences between the ACC and private insurers arise from the fact that the ACC has a monopoly in a substantial part of the insurance market in New Zealand, purchase of the insurance cover provided by the ACC is mandatory, and it collects compulsory levies rather than voluntary premiums through a variety of channels. Although these features of the ACC mean that it exhibits a range of organisational and administrative differences from

private sector insurers, we regard these as inherent in the ACC's monopoly mandate rather than inherent to the distinction between ACC and private insurers. Because we have been explicitly requested to consider the merits and feasibility of competitive private delivery of the accident compensation scheme, we have focused our attention on the similarities and differences between the ACC and private insurers that would remain if private insurers were also to deliver compulsory insurance where the cover was set by government.

- 75 The ACC claims to focus on minimising costs and maximising value to levy payers, including until recently maximising value to claimants, whereas competing private insurers focus on maximising shareholder value. Although this distinction may seem important, in practice it is more apparent than real. Private sector insurance companies maximise value for their customers because this is the way in which they compete with other insurers offering similar products, and the way they ensure that they have the customer base to maximise shareholder value. Private insurers don't need to assert they maximise value to customers, because if they do not they will not be able to continue in the market. The ACC can assert it is maximising value to levy payers, but in the absence of competition there is no way of knowing whether it does.
- 76 Both the ACC and private insurers offer insurance products, but under compulsory accident compensation private insurers would be required to compete for market share whereas the ACC manages the whole market. As a consequence the ACC does not need staff to engage in competitive activities, including sales and marketing. ACC also uses government information and revenue collection mechanisms that may not be appropriate for private insurers to access.
- 77 Customers of private insurers can self-select products in the private insurance market as a supplement to the compulsory cover that they are required to purchase, whereas the ACC is not able to provide cover beyond that specified by legislation. Private insurers make much greater use of differential pricing, including experience rating, to reduce moral hazard and motivate behaviour that reduces the risk of accidents.
- 78 Because of its market-wide mandate, ACC invests in campaigns that are generic and aimed at the general public rather than the individual customer. However, it is likely that if compulsory accident compensation was delivered by private insurers, similar campaigns would be run either by current partner agencies (police, health) or by co-operation between the private insurers.
- 79 The ACC is distinctive from private insurers in having a direct relationship with government. The ACC has its own Act of Parliament, is the primary vehicle by which government accident compensation policy is implemented, has obligations to provide services and advice to Ministers, and has its levies set by government. Private insurers may lobby government for policy or legislative changes, but the ACC can provide advice

directly to government on its legislative and regulatory environment. The ACC is also exempt from paying income tax, and from regulations and legislation covering the private insurance industry because of its government ownership, its lack of explicit equity capital, and the assumption that it should be responsive to government priorities and objectives without constraint. The closeness of its relationship with government means that the ACC has an implicit government guarantee of its liabilities, but this closeness to government may also mean that it is required to pursue policies that undermine its financial stability or have levies set at rates that are too low to meet the expected cost of claims.

- 80 The ACC has a Board and is also monitored by the government through the Department of Labour and The Treasury. The ACC is also monitored by the public and a range of lobby groups who express views about the levies set, the range of contingencies that it compensates, and the quality of its service. Private insurers are monitored by their boards, by their shareholders, and by the broader equity markets in which their shares are traded as well as by their customers and their competitors. Weak management of insurance companies may be disciplined by any of those monitoring vehicles, as well as by the threat of takeover. In addition private sector insurers must submit to prudential oversight and standards set by regulators, and meet international financial reporting standards.
- 81 ACC is required to consult widely on the levy rates that it recommends, and its recommendations are subject to substantial scrutiny within the public sector and by the public. The setting of levies for the ACC is a political process whereas the setting of premiums by a private insurer is a competitive process driven by the need to maintain financial solvency.

## Insurance risks in the ACC Scheme

- 82 For the services provided by the New Zealand Accident Compensation Scheme to be classed as insurance, it must be true that:
- the insured parties can be identified, and a premium paid on behalf of that party
  - specific contingencies are insured against, and a specific schedule of benefits is payable in the event of the occurrence of those contingencies
  - the contingencies covered are more predictable in a large sample of the population as a whole than they are for any individual
  - the frequency and value of claims on the accident compensation scheme are affected by the incentives established by the form and value of the compensation benefits provided.
- 83 In the table below we summarise our assessment of the insurance component of each Account against these criteria.

<b>Assessment of the operation of existing ACC Accounts against insurance criteria</b>				
	Insured can be identified, and premium collected from them	Specificity of contingencies, and associated benefits	Greater predictability of contingencies at population level	Frequency and value of claims affected by premium levels and value of compensation
<b>Work Account</b>	✓	✓	✓	✓
<b>Earners' Account</b>	✓	✓	✓	✓
<b>Motor Vehicles Account</b>	✓	✓	✓	✓
<b>Non-Earners' Account</b>	No	✓	✓	No
<b>Treatment Injury Account</b>	?	✓	✓	?

- 84 For each of the Work, Earners' and Motor Vehicle Accounts, we consider that all of the key requirements for competing private insurers to deliver the insurance cover are met. However, for the Non-Earners' Account there are substantial difficulties in identifying the insured party and, because they are not earners, in many cases there will also be difficulties in collecting a premium from them. The absence of a direct mechanism for the levy and collection of a premium on the insured non-earners also makes it doubtful whether the incentive effects provided by premiums and the level of compensation offered will affect the frequency and severity of claims. With respect to the Treatment Injury Account there is at present a lack of clarity about the levy mechanisms, and whether the levies are being paid by those who are insured or those who have the capacity to react to incentives that would affect the frequency and severity of claims.
- 85 The ACC legislation provides that health professionals may be levied. However, this has never been implemented, and the Treatment Injury Account is funded by the Earners' and Non-Earners' Accounts only. ACC has indicated its intention to implement the existing legislative provisions in future, so it may be possible to treat this Account as insurance also.
- 86 The fact that ACC's Work, Earners' and Motor Vehicle Accounts do cover insurance risks is also demonstrated by the incentive mechanisms that have been introduced into the Scheme. Perhaps the most important is the provision of co-insurance for income replacement. With only 80% cover for lost income the ACC Scheme provides a material proportion of co-insurance. This differs, however, from the cover that the private insurance industry might provide because it offers only one combination of premium level and co-insurance, whereas private sector insurers would commonly recognise the differing cost and incentives associated with different levels of co-insurance and offer several combinations of cover at differing premium levels. The combination of co-insurance of

lost income and compulsory membership of the Scheme go some way to addressing the problems of moral hazard and adverse selection that are central to private sector insurance contracts.

- 87 In addition to these aspects of the underwriting of accident insurance, a significant feature of the claims arising from coverage provided by the ACC Scheme is the potentially long duration of claims associated with disability and incapacity for work. Where the claim is potentially of long duration the expected present value of that claim will be large, but can be reduced through efficient claims management and in particular the implementation of effective rehabilitation and return to work practices. This situation also occurs in the private insurance domain, and is a characteristic of the claims arising from private disability and income replacement insurance. In the presence of these potential “long-tail” claims, the quality of the services that insurers provide to claimants and employers in facilitating early and effective return to work is a key component of the value that they add. And where the premiums paid by employers reflect the underwriting experience, effective accident prevention and claims management feeds directly into a reduction in the accident insurance premiums that employers are required to pay.

## Accident compensation in the context of the wider market for insurance

- 88 In Section 2 we noted that the Woodhouse Report demonstrated an understanding of the complementary nature of accident insurance and other lines of insurance, and made an explicit choice to create a distinctive comprehensive accident insurance market with a monopoly state insurer that was precluded from writing other lines of insurance business. In this section we consider some of the issues raised by that strategy.
- 89 The table below summarises the business of the ACC Scheme and related or cognate lines of insurance provided by competing private sector insurers in New Zealand. Taking the estimates in this table as an indication of the scale of the general, commercial, health, and disability insurance market in New Zealand, the business of the ACC Scheme makes up around 42% of the total market.
- 90 The market position of the ACC Scheme is based on drawing a distinction between insurance for the costs or personal injury arising from all accidental causes, and all other causes of personal injury. This distinction between accidental and other causes of injury is one created by regulation and not one that the insurance industry itself would impose. For example, in a market that did not have such comprehensive regulatory separation of a statutory level of insurance for accidents, the insurance contracts written would be driven by the pursuit of efficiency through the minimisation of transaction costs, the spreading of fixed costs, and the reduction of informational asymmetries. This means in practice that private insurance companies would be likely to:

- offer policies that provide the statutory level of cover together with options to take higher levels of cover in a range of different dimensions
- offer income replacement policies that include the statutory level of cover but in addition provide insurance against loss of income from all sources. There are currently more than 400,000 private income replacement insurance policies in force in New Zealand, all of which are written by private insurers but must reflect the complex interaction with the cover and benefits provided by the ACC Scheme.
- offer policies that provide the statutory level of benefits in respect of medical treatment and social rehabilitation, and in addition provide the option to extend those benefits for treatment and rehabilitation required from any cause
- offer motor vehicle insurance that combines insurance for loss to the vehicle with personal injury insurance. Since almost all accidents that result in personal injury will also result in loss to the vehicle, and loss to the vehicle will only occur in isolation through theft or damage to a parked car, the common elements in the information across these different lines of insurance are clear.

<b>Comparison of the net revenue of the ACC Accounts and major lines of private insurance sold in New Zealand<sup>15</sup></b>	
<b>Work Account</b> Net levy revenue \$540 million	<b>Commercial, Marine and Earthquake</b> Gross written premiums \$770 million
<b>Earners' Account</b> Net levy revenue \$1,112 million (includes residual levy revenue of \$18 million)	<b>Health, Disability, and Income Replacement</b> Gross levy income \$1,100 million
<b>Motor Vehicle Account</b> Net levy revenue \$739 million (includes residual levy revenue of \$393 million)	<b>Motor Vehicle</b> Gross written premiums \$1,250 million
<b>Non-Earners' Account</b> Net levy revenue \$982 million	<b>Domestic</b> Gross written premiums \$790 million
<b>Treatment Injury Account</b> Net levy revenue \$315 million	<b>Liability and Professional Indemnity</b> Gross written premiums \$280 million
<b>Residual Claims Account</b> (now in the Work Account) Net levy revenue \$496 million	<b>Other General Insurance</b> Gross written premiums \$320 million
<b>Total (excluding residual levy revenue from all Accounts)</b> <b>\$3,276 million</b>	<b>Total</b> <b>\$4,510 million</b>

<sup>15</sup> Private insurance excludes term and traditional life insurance products, but includes health, income replacement, and disability insurance sold by all other general, life, and health insurers. The gross premiums written are estimates based on Insurance Council of New Zealand (2009), Davies Actuarial and Financial Ltd (2009), Investment Savings and Insurance Association (2009) and the annual reports of companies not included in these surveys. Private insurance data are estimates in part because of the variation in reporting dates of individual firms.

91 These examples suggest that the creation of a statutory monopoly provider of insurance for accidents has had a material impact on the structure and size of the private insurance market in New Zealand. More importantly from the perspective of efficiency, it has increased the costs to consumers of obtaining the full range of insurance cover that they desire by establishing an artificial barrier between cognate lines of insurance. Efficiency would be increased if insurers could offer comprehensive cover in a single policy, reducing the transaction costs created by the regulatory boundary between the two forms of insurance and also the adverse selection associated with an insurance scheme offering accident-only cover (in which case there is an incentive to identify accidental causes of any injury).

### The boundary between accidents and illness

92 The ACC Scheme was founded on the idea that there is a clear distinction between harm caused by accident and harm from other causes. In some cases the distinction is clear, but in many cases it is not. For example, recent research conducted for the ACC<sup>16</sup> has demonstrated that people recorded as having a chronic health condition have twice as many ACC claims each year as people who are not recorded as having a chronic health condition.

93 The significance of this boundary is demonstrated by the fact that Scheme costs are increasingly being driven by people with a combination of injury from accidental causes and pre-existing psychosocial and medical conditions, particularly in the Non-Earners' Account. These pre-existing conditions increase the risk of injury and slow the rehabilitation process.

94 The boundary between illness and accidents is particularly difficult to define for elderly people who have pre-existing conditions at the time of injury. If elderly people who have problems with mobility or balance as a result of existing medical conditions fall and break their arm, was this even an accident or should it be treated as a complication of the underlying medical condition? Similarly, an injured person with diabetes will typically take longer to recover from an injury than a person without this pre-existing condition. If the portion of the population over age 65 years increases (as it is projected to do) and the portion of the population with chronic conditions such as diabetes, hypertension, and asthma increases, the costs associated with accidents that are at least in part a result of pre-existing medical conditions will grow substantially.

95 The complexity of the situations where there is a correlation between morbidity caused by ill health and by accidents creates three problems for the ACC Scheme. First, if the benefits provided by the ACC are more comprehensive or at a higher level than those provided by the health and social welfare systems, there will be pressure to classify an

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16 ACC paper to the Steering Group 25 September 2009 p.10

event as having arisen from accidental causes. Second, it invites cost-shifting from the health sector to the ACC Scheme, especially where primary reliance is placed on the diagnosis of health professionals in allowing access to the Scheme. Third, it invites an expansion of the definition of accident to include those conditions that are more and more directly caused by illness.

## Conclusion

- 96 The debate about whether the ACC is more usefully viewed as an insurance or a social welfare scheme is important because:
- to deny that there are social purposes in the creation of a compulsory no-fault compensation scheme is inappropriate
  - to deny that the ACC is also an insurance scheme is equally inappropriate. This is particularly because prohibitions on the use of mechanisms that improve the efficiency with which insurance can be provided risks creating challenges to the financial viability of the Scheme that may ultimately undermine our ability to support the Scheme's social purposes.
- 97 The ACC is part of our social welfare system in the sense that it is compulsory and it provides benefits that if not provided by the ACC would be provided at a lower level by the public health system or other social services. There is also no doubt that the Scheme is part of our health system in the sense that it funds a significant number of medical treatments.
- 98 However, when viewed from the perspective of social welfare programmes the ACC is distinctive. Social welfare schemes normally provide minimum levels of support regardless of past income, whereas the ACC Scheme provides income-related benefits based on the concept of recompense for losses incurred as a result of an injury. This means that the ACC is designed to address the opportunity cost of injury not the maintenance of minimum socially acceptable standards of living, and as such the benefits provided by the ACC are at much higher levels than social welfare programmes. In addition, social welfare schemes are normally funded from general taxation, reflecting the explicit cross-subsidies that are embodied in them, whereas the ACC is funded by levies associated with each individual Account.
- 99 On the basis of this analysis the Steering Group has reached the view that the accident compensation provided under the ACC Work, Earners', and Motor Vehicle Accounts is without question also properly regarded as insurance because:
- the insured parties can be identified, and a premium paid on behalf of that party
  - specific contingencies are insured against, and a specific schedule of benefits is payable in the event of the occurrence of those contingencies
  - the contingencies covered are more predictable in a large sample of the population as a whole than they are for any individual

- the frequency and value of claims on the accident compensation scheme are affected by the incentives established by the form and value of the compensation benefits provided.

100 The Woodhouse Report's conception of a compulsory no-fault scheme providing compensation based on actual losses for all victims of accidents in New Zealand is rightly regarded as a major contribution to public policy in New Zealand. But the Woodhouse Report also contained fundamental flaws in respect of the implementation of those ideas. In particular the problems with the Woodhouse Report include:

- inadequate consideration of the costs of segmenting accident insurance from other parts of the insurance market
- inadequate consideration of the difficulty of defining the boundaries between the health and social welfare systems
- failure to consider the costs of not utilising expertise in the private sector to allow private mechanisms to support the social purposes of the Scheme.

101 The delivery of a very wide range of compulsory insurance against accidents by a public monopoly insurer that is not permitted to write other types of insurance and makes very limited use of the approaches to the delivery of insurance that are fundamental to the efficiency of private sector insurers is unlikely to be the best way to ensure that we can afford to maintain the social purposes of the ACC Scheme. The approach taken to implementing the Woodhouse Report has introduced a range of inefficiencies into the New Zealand insurance market, in particular requirements for those who want to top up their insurance to over-insure and higher transaction costs resulting from the statutory separation of accident insurance.

## 4 Funding the ACC Scheme

### Introduction

- 102 The ACC has three sources of funding; levy income, Government appropriation, and investment income.
- 103 The basis on which the funding policy of the ACC is determined is the subject of some controversy and confusion. This is primarily because each new cohort of claims on the ACC creates liabilities to provide benefits over a period of time that may in some cases (where the potential for rehabilitation is low) be very long. Estimates of the claims liabilities of the ACC Scheme must therefore take into account a complex pattern of accident occurrence, claims, and benefits associated with claims, both in the period in which the claims are made and over the lifetime of the claims. Neither the methods and terminology, nor the conceptual rationale for the valuation approach used by actuaries to assess the financial position of the Scheme, are widely understood by members of the public. However, controversy and confusion also results because it is conceptually possible for the requirements to fund the liabilities of the ACC to be calculated in two different ways: on the basis of the funding that is needed to cover only the current period costs of past and current accidents (pay-as-you-go funding) or on the basis of funding the present value of the lifetime cost of the accidents occurring in the current period (full funding).
- 104 This section begins with an explanation of the levies associated with each ACC Account, the way in which the liabilities of the ACC Scheme are valued, and the way in which levy recommendations are produced. We then consider alternative funding strategies and the merits of full funding by comparison with other alternatives. Since the reported value of the liabilities of the ACC also includes a risk margin we consider the rationale for this margin and provide an assessment of its value in the case of the ACC.

### The current structure of Accounts and levies

- 105 The ACC Scheme is managed through five separate Accounts, each maintained for a specific purpose. Most of the Accounts<sup>17</sup> are funded through specific levies collected to meet the current and future costs of providing rehabilitation services and compensation for claims within each Account. Most Accounts have an operational requirement of full

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<sup>17</sup> The Treatment Injury Account does not have a levy but is funded by the Earners' and Non-Earners' Accounts; the Non-Earners' Account funding is by Appropriation.

funding of outstanding claims liabilities, which means that levies must be set on this basis.<sup>18</sup> These are shown in the table below.

**Table 5A: funding structure**

Account	Type of cover	Source of Funding	Average aggregate levy 2009 – 2010 (ex GST)	Forecast levy revenue 2009 – 2010 (\$ m)
Work Includes residual claims (costs of injuries from workplace accidents pre-1999 and Earners' non-work injuries pre-1992)	Work-related injuries	Employers Self-employed	75 cents per \$100 liable earnings [WA]	\$579
			56 cents per \$100 liable earnings [RC]	\$494
Earners'	Non-work injuries to Earners (eg, home, sport)	PAYE income Self-employed	\$1.51 per \$100 liable earnings	\$1,266
Non-Earners'	Injuries to non-earners (eg, children, elderly)	Government appropriation	n/a	\$1,053
Motor Vehicle	Personal injuries involving motor vehicles on public roads	Petrol levy Licensing fee	\$287 per vehicle (includes \$168 for residual claims)	\$862
Treatment Injury	Injuries from medical treatment	Earners' and Non-Earners' Accounts	n/a	\$315

## Fundamentals of valuation and funding policy

106 In insurance and superannuation schemes, solvency requires that the market value of current investments must be sufficient to pay the liabilities arising from all existing accidents. If premiums always cover the full costs of accidents expected to occur in each premium period, a fund that is initially solvent would be expected to continue to be solvent, if out-turns reflected expectations, or better. For social welfare schemes funded from taxes or levies, sustainability depends on whether the tax burden associated with the

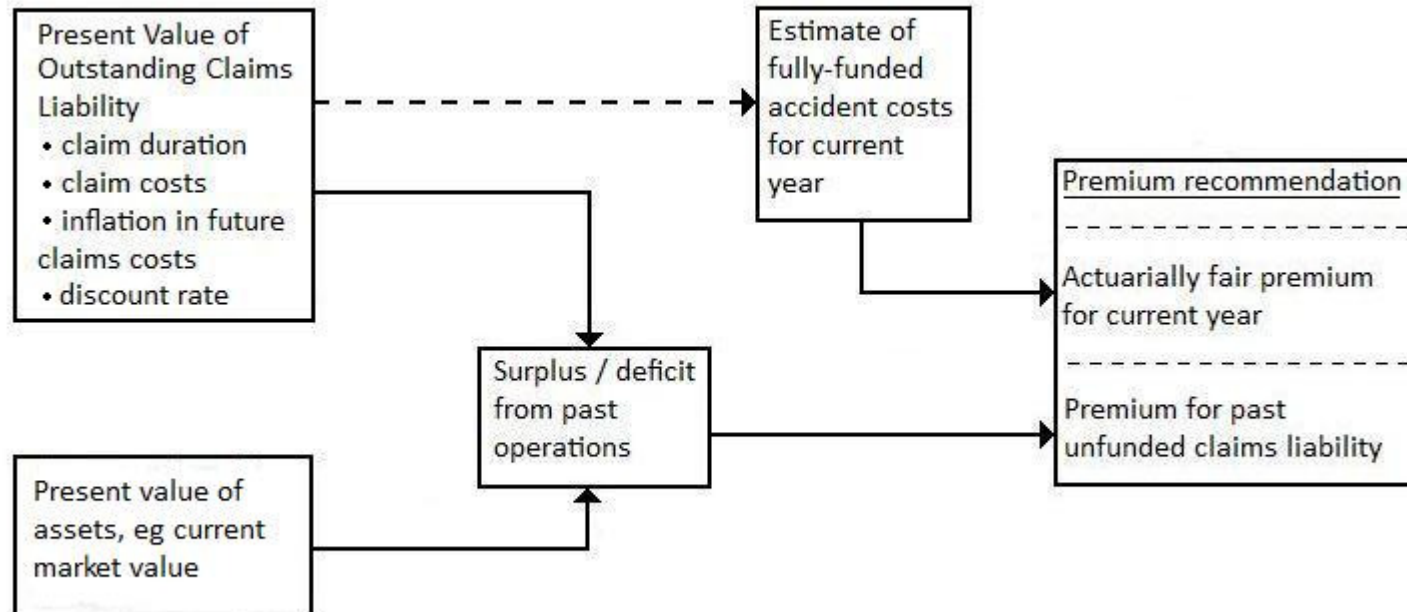
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18 Until 2001, all claims in the Non-Earners' Account were funded on a PAYG basis. In 2001 Cabinet decided that claims from 1 July 2001 would be funded on a fully-funded basis, while those prior to July 2001 would remain on a PAYG basis. Almost the entire Non-Earners' Account's unfunded liability relates to pre-2001 claims where there is a stated policy intention not to fully-fund these claims. Given ACC's investment performance this year, ACC expects that the post-2001, full-funded portion of the Non-Earners' Account will be overfunded at 30 June 2010. This will mean that the ACC will return funds to the Government in the form of seeking lower Appropriations.

scheme is sustainable. If the amount of tax that must be raised to fund the scheme is expected to grow much faster than national income the sustainability of the scheme will be uncertain.

- 107 Measuring solvency accurately is difficult because many of the key variables that will affect solvency in the future cannot be accurately predicted. The long-term nature of the liabilities of the ACC Scheme, arising from claims that may require the payment of benefits for many years, compounds the problem. It means that a large proportion of the payments made by the ACC each year are in respect of claims made in earlier years, and that the cost of each individual claim must be calculated as the expected present value of the payments that may be provided over a considerable period of time. The cost of each individual claim is therefore the annual value of the payments made multiplied by the duration of the claim. For the Scheme as a whole, the average duration of claims is a key determinant of total costs, and thus of the funds required for solvency. Small changes in average claim duration can have a substantial impact on the present value of the liabilities of such a scheme.
- 108 It is difficult to value the existing claims liabilities of the ACC because of their long-term nature and future uncertainties. Actuaries value these claims by assessing probability distributions and making assumptions about such matters as the future path of inflation, interest rates and medical costs. They discount projected future costs back to present-day terms, and it is this present value that is reported in the ACC's balance sheet as an actuarial assessment of its outstanding claims liability. This present value can be interpreted as the capital sum that would be expected to be able to fund the projected future payments, if it were invested in assets of the same risk category as is represented in the discount rate. For example, when actuaries use projected future government bond yields to discount the projected future liabilities, the calculated present value of those liabilities can be interpreted as determining the amount that would be expected, if invested in government bonds, to be able to fully fund the projected future liability payments.
- 109 The process of valuing the ACC Scheme is summarised in Figure 5.1 below.

**Figure 5.1 Estimating ACC Funding Requirements**



- 110 First, the value of the outstanding claims liability must be estimated. The key components in this estimation are:
- the nature of the entitlements associated with each existing claim and their distribution through time
  - the rates of inflation assumed to apply to each category of cost in the future. Some rates of inflation are related directly to inflation in wage and salary costs, but rates of inflation in medical treatment typically run well ahead of those for wages and salaries.
  - the discount rate at which the payments in future years will be discounted back to present values.
- 111 Critical in the determination of the funding position in respect of outstanding claims is the difference between the assumed rates of inflation in costs, and the discount rate. The higher is the discount rate by comparison with the assumed rates of inflation, the lower the outstanding claims liability will be. The discount rate used by the ACC at present is the risk free rate (the rate of return on long-term government bonds). Thus, assuming no change in the risk-free rate, the higher the assumed rate of inflation in the cost of benefits payable in the future, the higher will be the calculated outstanding claims liability. Alternatively, if the assumed rate of inflation in the cost of benefits is held constant, but the discount rate is increased to a higher rate than the return on long-term government bonds (which is equivalent to assuming that the long-term return on the asset portfolio will be higher than the risk-free rate), then the calculated outstanding claims liability will be lower.
- 112 The value of the assets held by the ACC is subtracted from the present value of the outstanding claims liability. If the present value of the liabilities is in excess of the value of the assets, then the Scheme has an unfunded claims liability.
- 113 Having determined the initial funding position in respect of the ability of investment assets to fund the costs of existing liability claims, actuaries next estimate the costs of claims for the accidents that they expect to occur in the next premium period. This requires an estimate of the full cost of the accidents that will occur in the next year, based on current exposure rates (numbers of persons covered in each account), injury rates, and the costs of the benefits associated with the claims that the ACC expects to receive. From this full cost, and estimates of the number of levy payers for each Account, the actuarially fair levies for each Account for the following year can be calculated. To these levies may be added a contribution to any past unfunded liability, the precise amount being a function both of the unfunded liability and the period of time over which the unfunded position is to be removed.

## Full funding vs pay-as-you-go funding

- 114 We can distinguish conceptually between three different approaches to funding social welfare, superannuation and insurance schemes.
- i **Full funding:** Premiums are set at a level that will fully fund all expected liabilities associated with the claims arising from accidents in the period covered by the premium. This means that premiums levied for insurance coverage in year  $j$  will provide funds sufficient to pay the costs associated with new claims made in year  $j$  as well as to provide a pool of funds that has, at the prevailing market interest rates, a present value equivalent to the present value of the expected future payments that will be made in respect of these new claims incurred in year  $j$ . It also implies that if an insurance scheme operating on such a basis for  $k$  years were to cease operations at the end of year  $k$ , it would be expected to have a pool of funds sufficient to meet the expected costs of claims incurred in years 1 to  $k$  even though some of those claims might continue for many years beyond  $k$  into the future.
  - ii **Pay-as-you-go funding:** Premiums or levies in any given year are set at levels that will meet the annual costs of the payments made by the scheme in that year, regardless when the accident upon which each claim is based occurred. Pay-as-you-go funding requires that the premiums set for year  $j$  must be equivalent to the expected value of payments made in respect of new claims arising in year  $j$ , plus the expected value of payments made in year  $j$  in respect of claims originating from earlier years 1 to  $j - 1$ . A key feature of a pay-as-you-go scheme is that it requires the ability to tax, in order to ensure that individuals meet the current period costs of the scheme even if this requires a premium rate that is greater than the expected value of the current period insurance benefits received.
  - iii **Partial funding:** Premium rates are set at levels that provide less than the full present value of liabilities arising from the claims expected to be made in the current period, but sufficient to fund some of the future liabilities arising from these claims. Partial funding can be viewed as the provision of a capital sum the investment income from which offsets a full pay-as-you-go premium to some degree.
- 115 Each of the three approaches to funding outlined above may provide a basis for solvency so long as there is a credible guarantor of the ability of pay-as-you-go and partially funded schemes to meet the cost of claims in the future. However, they allocate risk and incentives differently. These differences have extremely important implications for the efficiency with which the scheme operates.
- 116 Efficient insurance contracts link actuarially fair premiums to expected benefits as tightly as is possible given transaction costs and the presence of moral hazard and adverse selection problems. The efficiency of accident insurance schemes is affected by the extent to which the link between an individual's premium contributions and benefits is weakened or broken.

- 117 There are two broad methods of cross-subsidisation which impair this link between premiums and expected benefits in pay-as-you-go schemes. One is associated with schemes that are deliberately designed to transfer wealth, typically social welfare schemes. The second break in the link occurs when transfers are made between age cohorts.
- 118 In pay-as-you-go schemes transfers between age cohorts may arise due to changes to the range or cost of the benefits provided, to the demographic characteristics of the population and to the incidence of accidents. Even given a stable demographic structure and accident exposure, the transition to a steady state in a pay-as-you-go scheme will likely provide certain cohorts with benefits at the expense of others. For example, upon the introduction of a pay-as-you-go scheme, premiums will be lower for a given level of benefits because the premiums need to cover only the payments of the scheme for the first year of accidents. In the second year the premiums have to cover both the costs of the new accidents paid in that year and the ongoing costs of the accidents that occurred in the first year. This pattern continues until the scheme reaches a steady state, defined as the situation where the cost of new claims added to the scheme each year is balanced by the fall in the cost of past claims as earlier claimants return to work or transition to other benefits, taking into account population change.
- 119 The premiums of pay-as-you-go accident insurance schemes are not actuarially fair because they do not equal the present value of expected benefits. Because premiums that are not actuarially fair will be endemic in pay-as-you-go schemes, they are sustainable only because participation in these schemes is compulsory and relies on the ability to tax: therefore, government sponsorship is normally required for these schemes because only the government can make membership and funding contributions compulsory. This weak link between premiums and expected benefits represents a key inefficiency of pay-as-you-go schemes. Further, the weaker is the link the more the contribution will be regarded as a general tax that simply contributes to a consolidated fund, and the larger the consequent economic inefficiency.
- 120 Partial funding of the expected costs of an accident insurance scheme is an intermediate case. Partial funding may provide for greater stability in premiums than a pay-as-you-go scheme, because the partial funding may be used as a buffer against unexpected changes in current claims costs that would be reflected in premiums under a pure pay-as-you-go scheme. However, partially-funded schemes have in common with pay-as-you-go schemes the problem that premiums depart from the efficient (actuarially fair) level, and that the unfunded liability must be covered with premium income at some time. Thus, partially funded schemes raise problems of efficiency and transfer between different cohorts of levy payers, and also require government support to compel the payment of premiums to cover the unfunded liability. Partial funding may also reduce efficiency because in the absence of a specific funding target, funding in excess of the pay-as-you-go

premiums may be the subject of political opportunism (for example, through increases in benefit levels funded from scheme reserves or contribution or government contribution holidays).

121 Full funding is based on the fundamental principle that what we pay today should reflect the full costs of the injuries that we are incurring today, and that future generations will also pay the costs relevant to the injuries occurring in their society. The reasons why this principle is important are:

- in the absence of full-funding there is scope for non-transparent transfers between different groups or cohorts of levy payers. Claimants can obtain expected benefits in excess of the value of the premiums that they have paid only if another group is paying premiums that are less than the expected value of the benefits. The danger is that in an “immature” insurance scheme<sup>19</sup> where there are very long-term costs associated with accidents but premiums are not fully-funded, each generation will be tempted to provide itself with benefits that would not be affordable on a fully-funded basis by underfunding the insurance liabilities and failing to compensate for this in the overall government fiscal position. In this circumstance, the fact that the benefits are not affordable will become apparent only in the future, as the stock of claims that must be funded on a pay-as-you-go basis increases to the point where the burden on a future generation becomes too heavy and benefits have to be reduced.
- without full funding the premiums charged may change in any year in ways that are unrelated to current accident experience. For example, under a pay-as-you-go scheme employers may find that, despite reducing the frequency with which accidents occur at their workplace in successive years, their premiums must increase steadily to cover the growing cost of the stock of benefits being paid in respect of past accidents.
- fully funding the ACC allows the potential for competing firms who lack the power to tax to deliver accident compensation. Without fully funded premiums, private sector insurers would require a government guarantee of their liabilities to participate because the premiums set would be insufficient to cover the expected present value of the liabilities that they would be accumulating by writing that business.

122 The Steering Group therefore endorses the setting of levies on a basis that will fully fund the expected value of the liabilities arising from new claims on the ACC in any given year. We make this recommendation irrespective of whether or not competitive private delivery of accident compensation is introduced.

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<sup>19</sup> An immature insurance scheme is one that has been operating for a period that is less than the maximum term of the liabilities arising from the contingencies insured and benefits offered.

**Recommendation:** Levies should be set at the level that will fully fund the expected value of the liabilities arising from new claims in the year for which the premiums are collected.

## The risk margin in valuation of liabilities

- 123 Estimates of the present value of the liabilities of the ACC are uncertain because they depend on estimates of a variety of future costs and economic conditions. The actual costs that the ACC is required to pay could turn out to be significantly higher or lower than the costs estimated today.
- 124 To address these issues insurers add a risk margin to the estimate of the liabilities expressed to increase the probability that the assets will be sufficient to fund future liabilities. The appropriate margin should be consistent with the premium that private investors would require to bear the risk associated with variation in the value of the liabilities of the insurer.
- 125 The ACC Board has followed the regulatory requirements for and practice of public and private accident compensation insurers in Australia, as well as the requirements of the International Financial Reporting Standards (IFRS) adopted for the Crown's financial statements overall, in adopting a risk margin consistent with a 75 percent probability that its assets will be sufficient to fund the actual cost of its future liabilities. This added 12.8 percent, or \$2.8 billion as at December 2009, to the total liability of the ACC, and explains part of the increase in outstanding claims liability over the last 5 years that is analysed in section 5 below.
- 126 In a letter dated 11 December 2009 the Minister for ACC requested that the Steering Group consider whether the application and funding of a 75 percent risk margin for the ACC is appropriate given that the ACC is a Crown-owned monopoly provider of services, and whether it adds to the Crown's accounts and levies to an excessive extent. The request arises particularly because under current arrangements, solvency at current levy rates is not an issue for the ACC as a financial entity. The only limit to its ability to raise levies to fund future liabilities is the political willingness to withstand the adverse public reaction. More risk tolerance would imply a probability of sufficiency closer to 50 percent (and possibly even less). The public policy question therefore concerns whose interests this measure is serving and whether serving these interests is in the public interest.
- 127 Evidence relating to the willingness of those being insured to pay for additional security can be inferred from customary practice and regulatory requirements overseas. The IFRS and prudential regulatory standards that favour valuations that incorporate a 75 percent probability of sufficiency support this interpretation and of the application of the same standard in a New Zealand context in respect of the funding for accidents that have not yet occurred.

- 128 The next question is whether it is prudent for insurers, government-backed or otherwise, to set levies on the basis that the margin for error favours aiming to more than cover the future claims costs that are projected by actuaries exclusive of the 75 percent risk margin. The Steering group was clear that premiums for accidents expected to occur in the next premium period should cover the expected cost of claims for those accidents inclusive of the 75 percent risk margin loading. Our reason is that we understand that this loading represents best international practice.
- 129 With respect of levies set to cover the unfunded portion of claims arising from accidents that have already been incurred, the Steering Group considered that such a risk margin should also be applied to them if the liability for those claims was to be left on the balance sheet of the present ACC. We consider that it is undesirable to set up a bifurcated system for the ACC where future claims would have a risk margin if they were for anticipated injuries but not if they were in respect of future claims for past injuries.
- 130 If, however, the government ever restructured the ACC so as to separate the responsibility for pricing premiums for new business from the responsibility for funding the outstanding claims liability, this recommendation might need to be revisited. For example, a government considering such a move could also wish to consider the option of funding the unfunded portion of the outstanding claims liability from general taxation. The Steering Group's argument above for applying risk margin in respect of the funding of the unfunded liability from past claims would then no longer apply.
- 131 If the government considered that a risk margin was unnecessary, it could choose to fund the liabilities of the ACC at less than the value which incorporates the risk margin. Given the implicit government guarantee of ACC and the power of the government to set levies to cover past unfunded liability, funding at a lower level than the outstanding claims liability is feasible. However, so long as the government is committed to IFRS, the liability including the risk margin will continue to appear on the balance sheet of the Crown and any shortfall in assets will appear as unfunded liability.
- 132 It is important to treat the question of reporting standards for the ACC as a separate issue from the setting of levies, particularly in respect of accidents that have already occurred. The government could issue a directive that Crown-owned entities adopt a lower risk margin than 75 percent, but this would have two negative consequences. First, it might be regarded as a signal that the government was no longer committed to the high standards of public sector accounting and financial management for which New Zealand has become internationally renowned over the past 20 years. Second, a decision to adopt a lower risk margin, and thus to reduce the reported liabilities of the ACC, the Earthquake Commission, and any other Crown-owned agency with uncertain future liabilities, would not change the views of investment market participants about the financial position of the Crown. We consider that as long as the ACC remains as an insurer, it is appropriate that it reports to international standards in respect of its liabilities.

- 133 The Steering Group has considered whether the levies associated with unfunded liabilities from past operation of the Scheme should also be based on a definition of full funding that incorporates the risk margin. In our view, the same issues arise with these levies, in the sense that the levies are being collected to fully fund outstanding claims liabilities the precise value of which is uncertain. In this case, therefore, that application of the risk margin is appropriate.
- 134 We are aware of some proposals that the risk margin approach should be replaced by more sophisticated approaches that value the risk margin by adjusting the cost of capital, or by adopting a certainty-equivalent adjustment to expected future claims. Here the argument is that the risk margin is too “blunt” an instrument because it does not reflect variation in the risk of the business of individual companies. However, since the intended effect of these alternative approaches would be the same and international practice favours the ACC’s chosen approach, we see little merit in pursuing such possibilities.
- 135 The Steering Group therefore recommends that the decision of the Board of the ACC to operate within general public sector accounting guidelines by adopting a 75 percent risk margin in the valuation of the liabilities should be endorsed. If the government wishes to consider mandating a lower risk margin, then it should only do so based on a principled decision that considers the credibility of government financial reporting and the implications of the decisions for public entities other than the ACC, rather than focusing solely on the cost implications of the risk margin applied to the liabilities of the ACC under the current structural arrangements.

**Recommendation:** Endorse the decision by the ACC Board to define full funding of claims liabilities to include a risk margin consistent with national and international reporting and regulatory standards.

## Alternative views about the valuation and funding of the ACC

- 136 The Steering Group noted some alternative views suggesting that the adoption of generally accepted accounting principles and adoption of international financial reporting standards for the ACC is unnecessary.<sup>20</sup> We have considered those views and other opinions on which those views relied in making their suggestions. The reasons given for these suggestions include the claims that:
- actuarial calculations are estimates that are difficult to make, uncertain and subject to variation from time to time as market conditions (such as interest rates and inflation rates) change
  - the ACC Scheme is a social welfare scheme to which private sector accounting principles should not apply. In particular, like other social welfare schemes the

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<sup>20</sup> In particular, the submission of the New Zealand Council of Trade Unions (9 December 2009) and the views expressed to us by the ACC Futures Coalition (November 2009).

government has the power to change benefits provided by ACC, so there is no explicit contractual obligation on the government to provide the current level of benefits, and thus no need to report such an obligation in the Crown accounts.

- pay-as-you-go levies are more transparent, and if they were associated with the holding of reserves that partially funded outstanding claims liabilities any short-term fluctuations in the pay-as-you-go levies could be smoothed out.

- 137 The uncertainty of actuarial estimates of the outstanding claims liability is accepted, but we do not consider uncertainty in the estimate of the liabilities is a reason to ignore the information about the value of the liabilities that are being accumulated through the operation of the Scheme. Uncertainty arises in any calculation relating to the future, and so it is present even in respect of the setting of pay-as-you-go premiums, which will never exactly match the cost of the benefits provided in any given year.
- 138 Earlier sections of this report have provided a detailed critique of the assertion that the ACC Scheme is, and should be managed as, a social welfare scheme. However, the assertion that the government has the power to change the benefit levels provided by the Scheme deserves further comment because it demonstrates a failure to recognise one of the Scheme's most fundamental elements. The benefits provided by the ACC reflect the historical 'bargain' in which the potential victims of accidents gave up the right to sue those who may have caused their injury in return for the obligation to fund directly and indirectly a universal and comprehensive no-fault monopoly scheme. Thus, while the government does have the power to adjust benefits provided by the ACC Scheme, it seems likely that the historical and legal context in which the Scheme was created provides substantial limitations on the ability of the government to reduce benefits for financial reasons.
- 139 Some proponents of pay-as-you-go levies fail to address the problems of inefficiency that are inherent in an under-funded ACC Scheme, and in particular, do not address the costs arising from the setting of pay-as-you-go levies at rates that do not reflect the cost of the injuries occurring in any period, in any Account, or in any industry. Any benefits associated with the transparency of pay-as-you-go levies are outweighed by the reduction in efficiency that these provide by comparison with fully funded levies.
- 140 While the Scheme is still maturing pay-as-you-go funding creates the potential for inter-generational transfers and is inconsistent with long-term stability in the Scheme if the pay-as-you-go premiums required in the future became so high as to force radical changes to the Scheme, or even its abandonment.
- 141 The Steering Group has reached the view that the only area in which pay-as-you-go funding may have merit is specifically in relation to the unfunded liability relating to historical claims. These unfunded liabilities are a sunk cost of past operational problems with the ACC Scheme. One approach that would minimise deadweight losses would be to

separate the historical unfunded liabilities from the existing Scheme and to fund them from general taxation on a pay-as-you-go basis.

## Investment management

- 142 The Stocktake terms of reference require comment on the contribution of the ACC's investment portfolio to Scheme sustainability and levy stability, on the process for reserves management, and on the scrutiny of the investment function provided by the Board. In forming its views on investment management at the ACC the Steering Group has relied upon a review commissioned by the Corporation and conducted by Watson Wyatt, and comments on that review provided by the ACC, The Treasury, and the Department of Labour.
- 143 The financial projections of the ACC are based on earning a return that is slightly better than the return available on government bonds. This projection is (and has proved in practice to be) relatively conservative, balancing the risks faced by the Scheme resulting from inflation in claims costs at higher than expected levels. The ACC Annual Report records that sustainability and levy stability are the core objectives of investment management:
- The investment portfolios managed to balance the objectives of optimising returns (which allows the ACC to lower average levies over time) and managing the risk that the ACC could have to significantly increase levy rates in order to meet its obligations to injured people.
- 144 The investment strategy of the ACC has been successful to date, and the Steering Group is not aware of any aspect of the investment strategy that presents a major challenge for the sustainability of the Scheme. The ACC has a strong and suitably qualified team of investment managers, and its scale relative to the size of New Zealand investment markets gives it advantages over other investors. Investments are allocated to individual Accounts to allow appropriate matching of maturities and management of risk. The return on the ACC bond and equity portfolio has exceeded the return on benchmark portfolios in 16 of the last 17 years, including over the period of the global financial crisis of 2008-09.
- 145 Almost 50 percent of the reserves of the ACC are invested in government bonds. Bonds generate a stable return and are of relatively low risk. This investment in bonds partially protects the ACC against interest rate risk associated with the actuarial valuation because when interest rates fall the Scheme's liabilities increase, but the value of fixed interest rate securities such as bonds also increases. This hedge against changes in the present value of Scheme liabilities would be enhanced, and risk to the government reduced, if the ACC held a higher proportion of government bonds, and in particular, if it invested in bonds with maturities that matched the term profile of the liabilities. If the ACC's balance sheet is solvent on a fully-funded basis, its assets invested in government bonds will suffice to fund the projected future costs of accidents that have already occurred. This is because it is current practice for liabilities to be discounted using government bond yields. While

investing some portion in equities raises the expected portfolio return, it also increases the variance in the returns.

- 146 Where the investment of 50% of the ACC investment portfolio in higher risk investments such as equities and commercial property allows the ACC to earn “windfall” returns that exceed the returns incorporated in its financial projections, how these returns are used will be important for levy stability. The significance of the relationship between the treatment of higher investment returns and levy stability is enhanced by the fact that the ACC has no equity capital. This means that there is no buffer between short-term investment returns and the value of the reserves required to meet the future costs of existing claims. There is, in other words, a danger that the combination of ACC’s capital structure and its investment policy may result in undesirably large volatility in levies. In particular:
- 147 Higher than average investment returns may, if built into financial projections, induce complacency about the need to control claims costs. Downturns in investment returns (such as have occurred in the last two years) may not be mirrored in reductions in claims costs with the result that the underlying pattern of cost increases may suddenly look unsustainable.
- 148 It will be attractive for any government to allow higher than average returns to be impounded into lower levies in the short term rather than treating some of those returns as windfall gains that should be held solely as a buffer against unforeseen contingencies that would otherwise require increases in levy rates in the future.
- 149 The combination of the absence of equity capital in the ACC, an investment policy that allows returns substantially above the government bond rate to be earned in many but not all years, and the political pressure on governments to keep levies as low as possible are therefore likely to lead to greater volatility in levy rates than is desirable. For this reason it is important for future levy stability and control of costs that unless it moves to an investment policy that focuses even further on investment in fixed interest securities with maturities matching the term structure of its liabilities, the ACC should:
- not build higher investment returns derived from good years into its long-term actuarial valuation (ie, that it avoid assuming for purposes of the actuarial valuation that the long-term rate of return on its investments will be the return earned in the “good” years)
  - use any investment returns in excess of those projected in the actuarial valuation to reduce the unfunded liability rather than to reduce levies for as long as there is unfunded liability and no equity capital in the ACC
  - allow any investment returns in excess of those projected in the actuarial valuation to increase the Crown’s equity in the ACC rather than reduce levies if the ACC should have equity capital at any time in the future.

150 Even if these issues relating to the treatment of higher than average returns were solved, and certainly while they remain, it would not be appropriate for the ACC to invest a higher portion of its portfolio in traded domestic equities or in private equity. As the size of the ACC portfolio grows relative to the size of the New Zealand economy and the New Zealand equity market it would be increasingly difficult for the ACC to invest all of its funds in New Zealand equities. There is also a danger that a broader mandate to invest in unlisted securities would create undesirable opportunities for pressure to be applied for investments to support government strategies rather than solely focussing on investment performance. Any required increase in the holdings of domestic equities and unlisted securities may increase the risk that levy payers bear in relation to ACC investment performance. The Steering Group therefore does not recommend any changes to the ACC in respect of investment management.

151 The ACC holds one of New Zealand's largest investment portfolios so it is appropriate that it strive for the highest quality of investment performance. This suggests that the ACC should:

- have access to the highest quality of investment advice in respect of the investment of its portfolio
- undertake explicit and formal development of its investment strategy, including of the risk associated with the overall asset-liability portfolio (that is, the level of year-to-year variation in the returns on the portfolio and potentially also volatility in levies that the ACC is prepared to tolerate in order to achieve average returns in excess of the government bond rate)
- have on its Board people who are sufficiently well versed in investment and financial markets that they can actively contribute to the Board's governance role in relation to this function.

152 Recent appointments to the ACC Board have increased the number of Board members who have explicit expertise in investments, and thus the capacity of the Board to provide effective governance in this area.

**Recommendation:** There should be no requirement for the ACC to change its investment policies, and in particular, no requirement to increase the ACC's investment in domestic equities.

## Conclusion

153 Fully funded premiums to cover accidents that have not yet occurred are required to achieve efficient and sustainable outcomes in an insurance scheme even though pay-as-you-go funding is common for social welfare schemes. Fully-funded premiums are efficient in the sense that they provide for a clearer link between the accident experience today and the premiums that are being paid. Fully-funded premiums avoid the inequity of departures from actuarially fair pricing and potentially minimise the deadweight costs of levies that are higher than this level or the taxes that are necessary to fund shortfalls.

Fully-funded premiums also ensure that the government and levy payers must face up to the true cost of any changes to the scope or entitlements in the scheme. Pay-as-you-go and partly funded schemes become unsustainable because they facilitate political decisions to expand the benefits and defer facing up to the costs.

- 154 Proponents of pay-as-you go levies to cover accidents that have not yet occurred do not address issues of efficiency in the ACC Scheme, and in particular, do not address the costs arising from the setting of pay-as-you-go levies at rates that do not reflect the cost of the accidents occurring in any period, in any account, or in any industry. Proponents of pay-as-you-go levies for immature schemes commonly illustrate the political pressures to confer immediate benefits on some at the expense of greater costs for others. These may include future generations. Such pressures should be resisted.
- 155 The investment strategy of the ACC has been successful to date, and the Steering Group is not aware of any aspect of the investment strategy that presents a major challenge for the sustainability of the Scheme. We do not support any direct political intervention in the investment policy of the ACC, and in particular consider that any direction to invest in ways that supported government economic development strategies would have the potential to impair the financial stability of the Scheme.
- 156 The decision of the Board of the ACC to operate within general public sector accounting guidelines by adopting a 75 percent risk margin in the valuation of the liabilities should be endorsed. The presence of an implicit government guarantee or the ability to impose levies for past unfunded liability are relevant to the solvency of the Scheme because they bear on the likelihood of having assets sufficient to meet the outstanding claims liability, but they are not relevant to the valuation and the variance of the outstanding claims liability, and it is the latter that the risk margin addresses.

## 5 Performance of the ACC Scheme

### Introduction

157 In this section we provide an analysis of the causes of the increase in the outstanding claims liability that has prompted the current concerns about the financial sustainability of the Scheme. We consider the contribution of all relevant factors, including accounting, policy and legislative changes, rehabilitation performance, medical, weekly compensation and social rehabilitation costs, and accident rates.

158 We begin by considering the major components in the increase in outstanding claims liability for the Scheme as a whole, and then provide a more detailed analysis of performance for each individual ACC Account. Following that analysis we consider the available evidence on accident rates before presenting our conclusions.

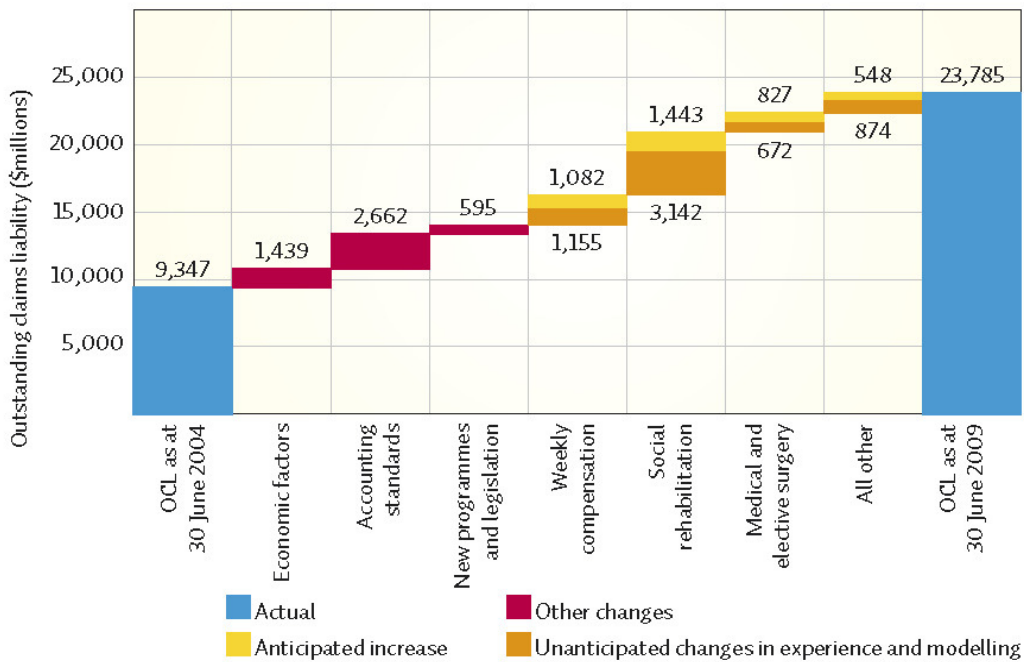
### Scheme-wide financial performance

159 The Scheme-wide outstanding claims liability (OCL) for all ACC Accounts increased from \$9.347 billion in June 2004 to approximately \$23.79 billion in June 2009. While ACC assets increased during the same period, they have failed to keep pace with the OCL, with the result that the performance of the ACC Scheme in relation to the target of full funding deteriorated.

160 The size of the OCL is important only to the extent there is gap between the OCL and the assets of ACC. In principle, if there are enough assets to match the OCL then the size of the OCL itself would not be important. What is critical about the sizeable growth of the OCL since 2004 is that it outstripped by a wide margin the growth in ACC's assets. As of June 2009, there was a \$13 billion gap between ACC's assets and its OCL, though the most recent forecast for 30 June 2010 is for a smaller gap of approximately \$10.5 billion. It is this gap that is the source of current concerns about ACC's financial sustainability.

161 The following graph decomposes the \$14.4 billion increase in the OCL between 30 June 2004 and 30 June 2009 into seven categories. Four of these are divided into two subcategories of anticipated and unanticipated changes. Anticipated changes are those anticipated by the ACC's actuaries and incorporated in valuations. Unanticipated liability growth is due to inadequate forecasting, poor Scheme management (in particular, Scheme management that did not view the assumptions of the actuarial valuations as performance targets), or a combination of the two.

### Trends in the outstanding claims liability



162 The dramatic increase in both the OCL and the gap between the OCL and the assets is the result of three main factors: one-off changes to valuation methodology (18% of the total), economic factors (10%), and increases in claims costs due to factors such as declining rehabilitation rates (67%).

163 Increases in claims costs have been the primary driver behind the ‘unanticipated’ rise in liabilities that amounted to \$5.843 billion as at June 2009. The drivers for this increase in costs were: the increasing number of new claims, the lengthening duration of claims, and increases in claim costs above inflation. As these three variables increased simultaneously, the OCL of the Scheme expanded rapidly. These factors were, to a significant extent, within the power of the ACC to manage.

164 The following table provides a more detailed breakdown of the contributions made by different components of the outstanding claims liability.

## Analysis of components of the increase in outstanding claims liability

Category	Total (\$m)		Components of total increase in unfunded liabilities		Increase as a % of 2004 liability of \$9347m		
			Anticipated	Unanticipated		Anticipated	Unanticipated
Economic factors	1439	10%			15%		
Accounting standards	2662	18%			28%		
New programmes and legislation	595	4%			6%		
Weekly compensation	2237	16%	7%	8%	24%	12%	12%
Social rehabilitation	4585	32%	10%	22%	49%	15%	34%
Medical etc	1499	10%	6%	5%	16%	9%	7%
All others	1422	10%	4%	6%	15%	6%	9%
	<b>14439</b>	<b>100%</b>	<b>27%</b>	<b>41%</b>	<b>153%</b>	<b>42%</b>	<b>62%</b>
<b>Alternative breakdown</b>							
Increase entirely out of management's control	4696	32.5%			50%		
Increase anticipated in 2004	3900	27.0%			42%		
Unanticipated increases in benefits	5843	40.5%			63%		
	<b>14439</b>	<b>100.0%</b>			<b>154%</b>		

- 165 The ACC Scheme was also negatively affected by changes of three types:
- changes to accounting standards, primarily the adoption of the 75% risk margin (see section 5)
  - changes to the discount rate used in the valuation (as risk free rates fell during the global financial crisis)
  - changes to the scope of entitlements resulting from legislation and court decisions.
- 166 Our analysis of the components of the increase in the outstanding claims liability between 2004 and 2009 may be summarised as follows:
- Only 27% of the \$14.4 billion increase was anticipated by the actuarial valuation in 2004.
  - Another 33% of the increase was outside the control of management, being due to changes in accounting standards, economic factors and legislation. These included:
    - changes to accounting standards, primarily the adoption of the 75% risk margin (see section 5)
    - changes to the discount rate used in the valuation (as risk free rates fell during the global financial crisis)
    - changes to the scope of entitlements resulting from legislation and court decisions.
  - The remaining 40 percent of the increase (\$5.8 billion) was the unanticipated cost increase for social rehabilitation, weekly compensation and medical costs. The drivers for this increase in costs were: the increasing number of new claims, the lengthening duration of claims, and increases in claim costs above inflation. These factors were, to a significant extent, within the power of the ACC to manage (inflation in medical treatment costs perhaps being an exception).
  - The contribution of new programmes and legislation was significant in financial terms (\$600 million) but a minor proportion of the overall increase in outstanding claims liability.
  - Social rehabilitation is overwhelmingly the most important single contributor to the increase in outstanding claims liability, representing 32% of the total, and 22% of the \$5.8 billion unanticipated increase in liabilities.

## Claims trends

- 167 The total number of new claims made to ACC has been steadily growing at rates in excess of the growth of population over the last decade. The financial performance of the Scheme could be improved if the overall rates of injury in New Zealand decreased, or if the growth in the number of accidents was stopped. The table below shows the total claims per year since 2005, as well the proportion of those claims by Account.

	2005	2006	2007	2008	2009
Total number of new ACC claims	1,601,553	1,684,077	1,753,962	1,755,899	1,752,452
Proportion of new Work Account claims	13.2%	12.2%	11.6%	11.7%	10.9%
Proportion of new Motor Vehicle Account claims	2.7%	2.6%	2.5%	2.5%	2.3%
Proportion of new Non-Earners' Account claims	48.8%	48.4%	47.6%	47.7%	48.4%
Proportion of new Earners' Account claims	35.1%	36.3%	37.8%	37.7%	38.0%
Proportion of new Treatment Injury Account claims	0.2%	0.2%	0.3%	0.3%	0.3%

168 The majority of claims that enter ACC (92%) only require one-off medical fee payments. This is where a claimant visits a medical provider, receives treatment, and requires no further action from ACC. These claims can involve a doctor certifying short periods off work (ie, less than a week) to recover. The other 8% of claims are called 'entitlement claims' because they involve payments for weekly compensation, social rehabilitation, or some other non-medical entitlement.

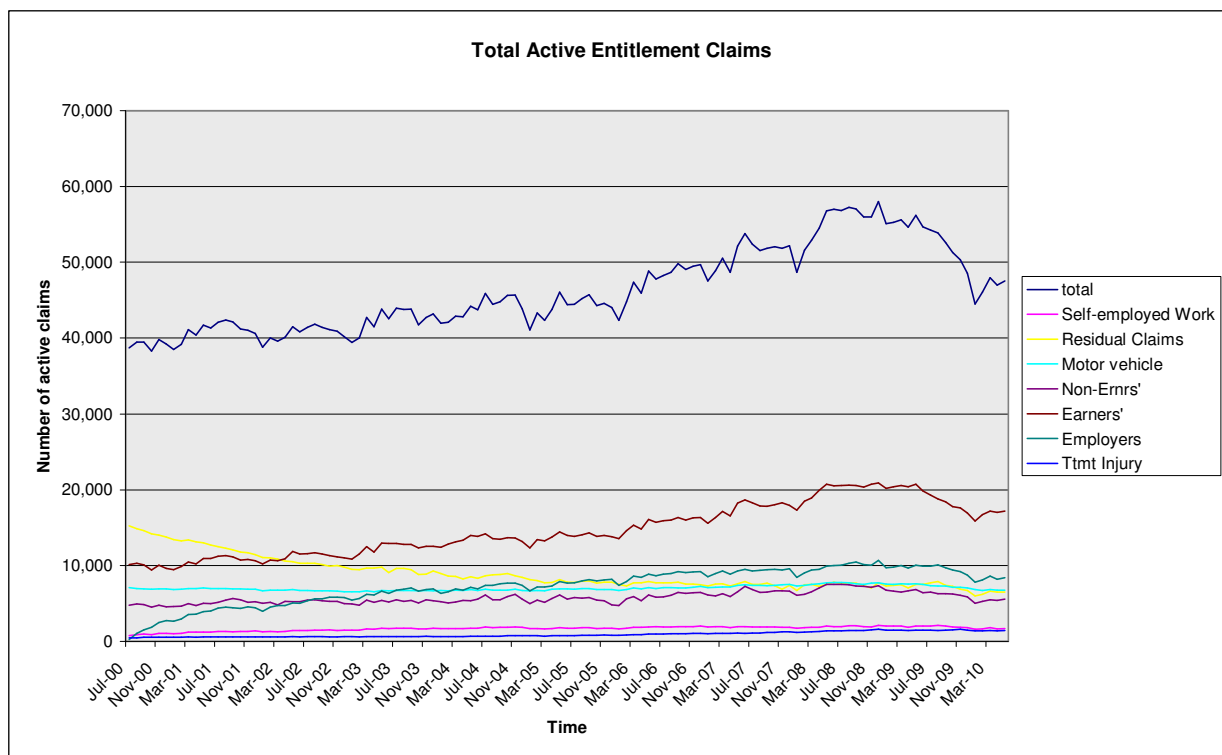
169 Given that weekly compensation and social rehabilitation are the two largest costs driving the OCL, it is prudent to examine the 8% of claims incurring those costs and determine into which Accounts most of these entitlement claims fall. The table below shows us the distribution of entitlement claims across the ACC Scheme for the last five years.

	2005	2006	2007	2008	2009
Total number of new ACC entitlement claims <sup>21</sup>	104,883	113,362	117,388	117,352	118,931
New Work Account entitlement claims	29,493	29,166	27,401	27,413	26,355
New Motor Vehicle Account entitlement claims	5,594	5,963	6,086	6,067	5,829
New Non-Earners' Account entitlement claims	22,253	25,322	25,966	26,038	27,527
New Earners' Account entitlement claims	46,808	51,778	56,395	56,296	57,310
New Treatment Injury Account entitlement claims	735	1,133	1,540	1,538	1,910

170 A graph plotting the movement of all 'active' entitlement claims (which include the weekly compensation claims as well as claims receiving other entitlements) at any given point in time over the last 10 years appears below.

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21 This number is only an addition of the number of entitlement claims by Account.



171 It is this growth in entitlement claims (ie, claims that result in weekly compensation or other entitlements) rather than total claim numbers that has the greatest financial impact on the Scheme. The Earners' Account, by a wide margin, contains the largest number of entitlement claims.

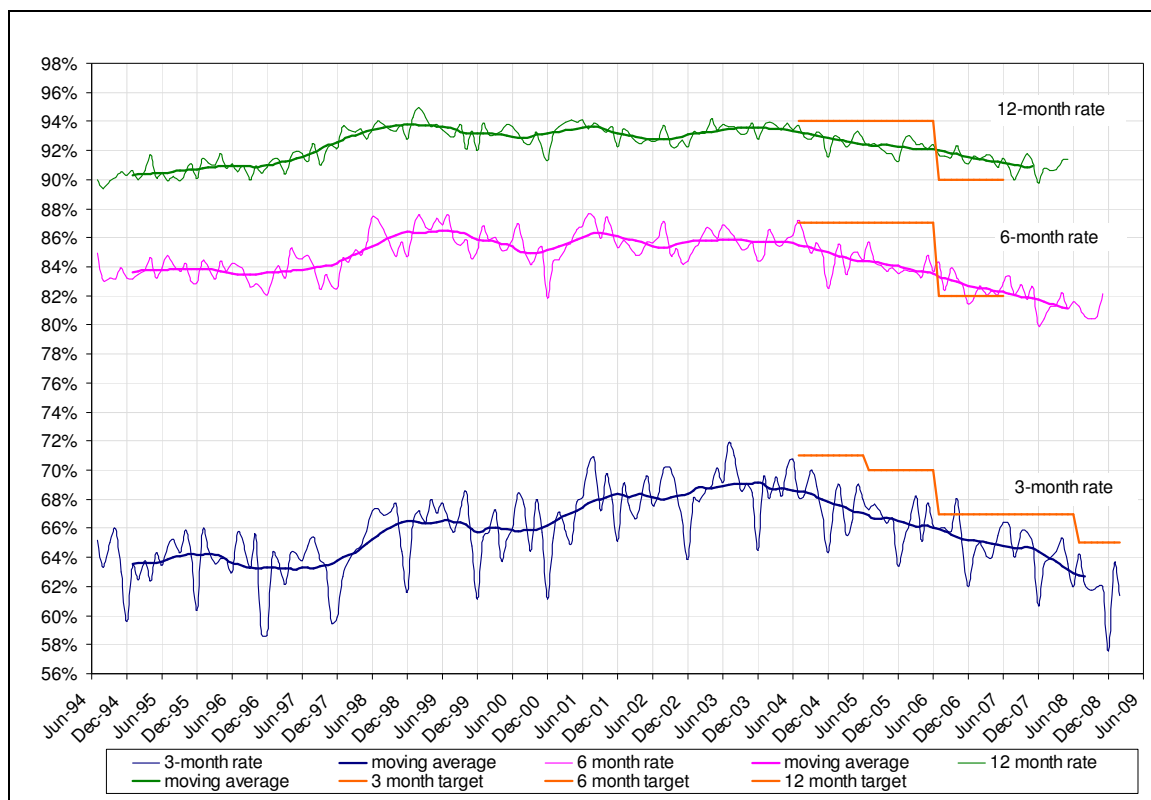
### Duration of claims and the growth of long-term claims

172 The long duration of some claims, and the consequential impact on the OCL, means that rehabilitation performance is critical. Poor rehabilitation performance results in claims persisting for longer on average, and thus in much higher costs. Claim duration accounts for \$1.155 billion of the unanticipated increase in the weekly compensation component of the OCL from 2004 to 2009. Beyond the impact of poor rehabilitation rates on the weekly compensation element of liability, claims of longer than 12 months are likely to be associated with large social rehabilitation costs. At the currently-estimated value of \$8.9 billion, social rehabilitation liabilities are even larger than the liabilities for weekly compensation (\$6.352 billion).<sup>22</sup> Shortening the length of time people stay on the Scheme is therefore critical to controlling this element of ACC's liabilities.

173 The chart below describes the overall ACC rehabilitation rates for three, six, and twelve months dating back to June 1994.<sup>23</sup>

<sup>22</sup> These figures are estimates for 30 June 2010 and do not include compensation for fatal injuries.

<sup>23</sup> The rehabilitation rate measures the percentage of entitlement claims that exit the ACC Scheme after a certain period of time. For example, if the six month rehabilitation rate is 80%, this means that only 80% of entitlement claims have exited the Scheme by six months from the date of injury.



174 Given the importance of the rehabilitation rate to overall Scheme costs and the primacy of return to work as a goal of accident compensation schemes, we consider that it is appropriate to expect returning people to work to be the pre-eminent goal of the ACC. Further, we have formed the view that historical performance provides the best guide to the performance targets that can be achieved by the ACC on an ongoing basis. We therefore note that the marked deterioration in rehabilitation rates since 2004 should be regarded as evidence of unacceptable performance on the part of the ACC. The ACC has tended to focus on the twelve month rehabilitation rate, but needs to focus to a greater extent on early intervention and managing the inflow into the tail of long-term claims. This suggests a greater focus on the three month rehabilitation rate. There is no reason why a three month rehabilitation rate of at least 70% should not be expected of ACC given that it was achieved in 2004.

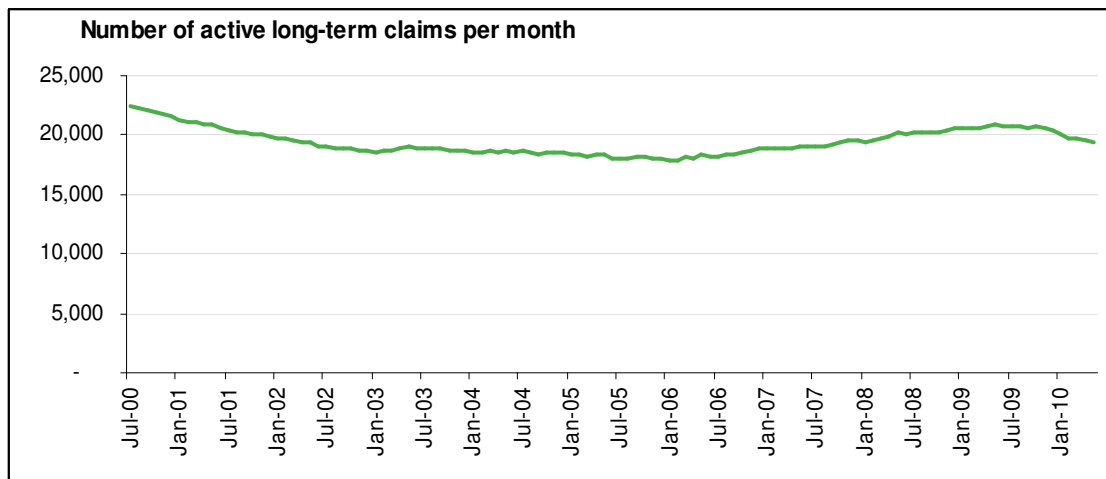
175 Since 2005 the long-term weekly compensation claims pool has grown from 12,780 to 14,205 (December 2005 to December 2009), an 11.1% increase (2.7% per annum). There has been an increase in new claims entering the long-term claims pool over this period, primarily driven by the 17% increase in new claims and a fall in the 365 day return to work (RTW) rate from 95% in 2005 to 93.1% in 2009. This numerically small drop in the 365 RTW rate nevertheless has a dramatic impact on the entries to the long-term claims pool.

For example, for every 30,000 new weekly compensation claims received by ACC, the change in rate means that 570 additional claims entered the long-term claims pool.<sup>24</sup>

176 The reasons for the increase in long-term claims over the period are not known with certainty, but it seems likely that the combination of the low co-payments associated with the ACC Scheme, initiatives to reduce barriers to accessing the Scheme, and a relaxation within ACC of controls on access to entitlements all contributed to the growth in claim volumes.

177 The long-term claims pool is made up of claims that have been receiving weekly compensation for a period exceeding 12 months. Seriously injured claimants can remain in the long-term claims pool for more than 40 years after the date of injury.

178 As at June 1998, there were nearly 27,500 long-term claimants on the Scheme, but that number declined over a long period before increasing again from 2005, as is shown in the chart below.<sup>25</sup>



179 The table below provides the make up of long-term claims pool by Account.

Account	2005	2006	2007	2008	2009
Work (incl Residual) <sup>26</sup>	6,982	6,780	6,842	6,883	6,807
Motor Vehicle	2,974	3,007	3,085	3,219	3,274
Earners'	2,695	2,945	3,352	3,921	4,379
Non-Earners'	299	313	339	371	398
Treatment Injury	271	303	310	361	413
<b>ACC total long-term claims</b>	<b>13,221</b>	<b>13,348</b>	<b>13,928</b>	<b>14,755</b>	<b>15,271<sup>27</sup></b>

24 In 2009 ACC received 62,500 new weekly compensation claims

25 This chart uses the figure of weekly compensation based long-term claims as well as non-weekly compensation-based long-term claims. The table figures do not include non-weekly compensation based claims. This explains the difference in the two sets of numbers.

26 This figure also includes long-term Earners' Account claims from before 1992.

27 This is the 30 June 2009 figure. By December 2009 it had dropped to 14,205. As at 31 March 2010, this figure had dropped to 13,804. This indicates that the pool of long-term claims is now dropping very rapidly.

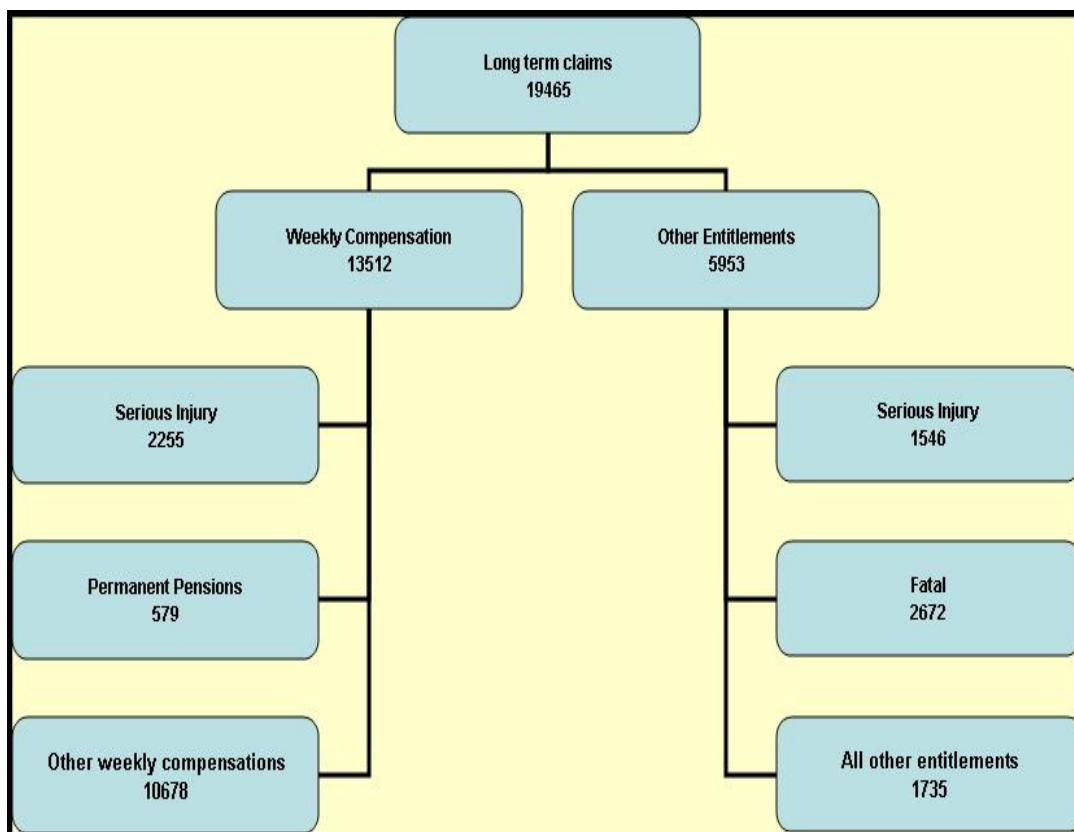
180 The total number of long-term claims in the Scheme continued to increase up to 2009, although the pool is currently shrinking again. The ACC advises that there are four trends currently driving the recent decrease in the long-term claims pool:

- reduction in the number of new weekly compensation claims entering the Scheme
- improving return to work rates in the first 12 months of a claim
- increased exit rates from the long-term claim pool
- more active management of claims than in the past and good signalling to Scheme gatekeepers (ie, health practitioners) that having claimants on the Scheme for long periods of time does not necessarily improve health outcomes.

181 The following diagram codifies the long-term claims by their type. Even though the number of long-term claims is tiny compared to the 1.7 million new claims received each year, they have a dramatic effect on ACC's bottom line. The influence of this small group of claimants on ACC's OCL is extreme. In addition, many people who are long-term claimants should reasonably be expected to recover from their injuries and return to work, based on the nature of their injury. We understand that many of the claimants in the 'other weekly compensation' pool are likely to exit the Scheme. In other words, many claimants in the long-term claims pool have injuries that would not prevent their return to work at some point. Serious injuries (ie, those for whom recovery is unlikely), as noted above, constitute only 3,801 of the 19,465 total long-term claims.<sup>28</sup>

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28 We note that the figure of 19,465 long-term claims is larger than the figure normally cited by ACC when referring to long-term claims. The figure normally cited is the long-term claims that are in receipt of weekly compensation. The 13,512 figure in the chart is therefore the normal figure used to refer to 'long-term' claims.



182 The figures in the chart above are as at 31 May 2010. Weekly compensation claims categorised as ‘serious injury’ are likely to require weekly compensation until the claimant is age 65. The ACC has established programmes to support getting these claimants back to work. However it is likely these claimants will not be independent of ACC financial support for lost wages over their entire working life and they have therefore been assessed by the ACC as ‘unlikely to exit’. Permanent pension is a legislative entitlement for a small number of historic claims and continues until the claimant reaches retirement age.

183 The chart above suggests that over half of the long-term claims are in categories that mean they are likely to be rehabilitated and exit the Scheme at some point. There should be rigorous performance monitoring of the ACC to ensure that rehabilitation targets consistent with this classification are achieved.

### Average cost per claim

184 We calculate the average cost per claim in the Scheme by taking ACC’s annual expenditure on rehabilitation and compensation for the last several years and dividing it by the number of ‘active entitlement claims’ in that year. This category of claims includes all new and existing entitlement claims for the year, including non-weekly compensation entitlement claims.

185 These figures should be used only as a general estimate of average claim costs in the Scheme. More precise estimates of costs per entitlement claim are referred to in the Account-by Account subsections below.

186 Dividing total annual expenditure on rehabilitation and compensation by total active entitlement claims for a given year gives us the following estimates of cost per claim.

	2006	2007	2008	2009
<b>Estimated cost per claim per annum</b>	\$44,745	\$45,150	\$47,874	\$56,005

187 This estimate does not include non-entitlement claims. The vast majority (around 92%) of ACC claims do not involve entitlements to weekly compensation or social rehabilitation, which are the main cost drivers for the Scheme. The value of these non-entitlement claims is much lower than the above estimates – perhaps only as much as \$200 per claim on average.

## The Work Account

188 The Work Account provides cover for employees and the self-employed for work-related personal injuries. Cover is also provided for treatment injuries sustained as an unexpected consequence of medical treatment for a work-related injury, and for non-work injuries suffered by earners prior to 1992. In March 2010 the former Residual Claims Account was merged into the Work Account.

## Financial performance

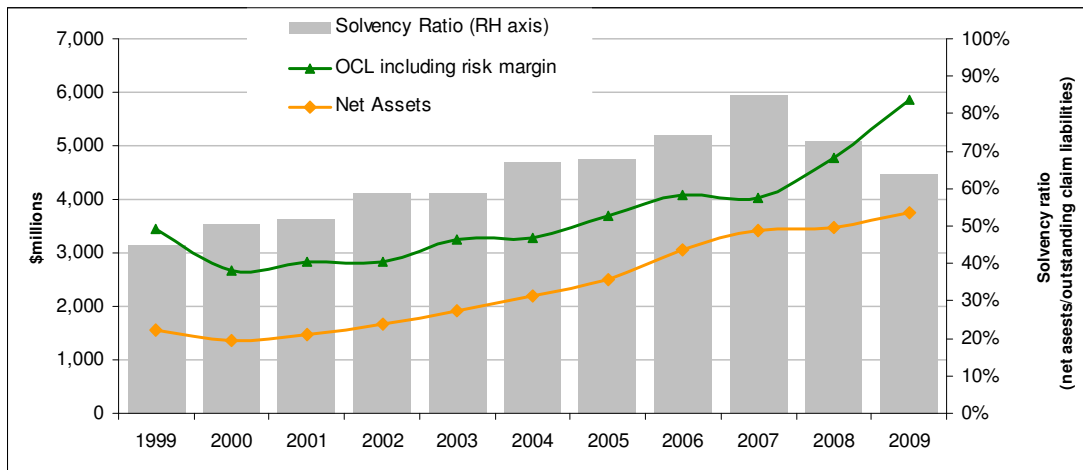
189 The Work Account had an unfunded liability of \$2.12 billion at 30 June 2009, and is in the best financial condition of all the Accounts. However, this aggregate figure hides the fact that as at 30 June 2009, the Work Account was 100% funded while the Residual Claims Account was only 40% funded. The Residual Claims Account is the Account that dealt with liabilities for workplace injuries that occurred before 1999, and non-work injuries to earners prior to 1992. It was merged with the Work Account in March 2010.

190 The levies for this Account were proposed by the ACC to increase from \$1.31/\$100 liable earnings in 2009/10 to \$1.89/\$100 liable earnings in 2010/11. The actual levy decided upon for 2010/11 was an average of \$1.47 across all risk groups. Part of the reason for this decrease from the rate ACC consulted on in late 2009 was the passage of the Accident Compensation Amendment Act 2010, which changed a number of policy settings in the Scheme and, more significantly, extended the timetable for fully funding residual claims from 2014 to 2019, allowing the cost of pre-1999 claims to be recouped over a longer period.

191 There are two components to the Work Account levy – a component to pay for pre-1999 claims, and a component to pay for the claims incurred in the current year. For the proposed rate of \$1.89, the pre-1999 component was 71 cents, while the component for the current year's claims was \$1.18.

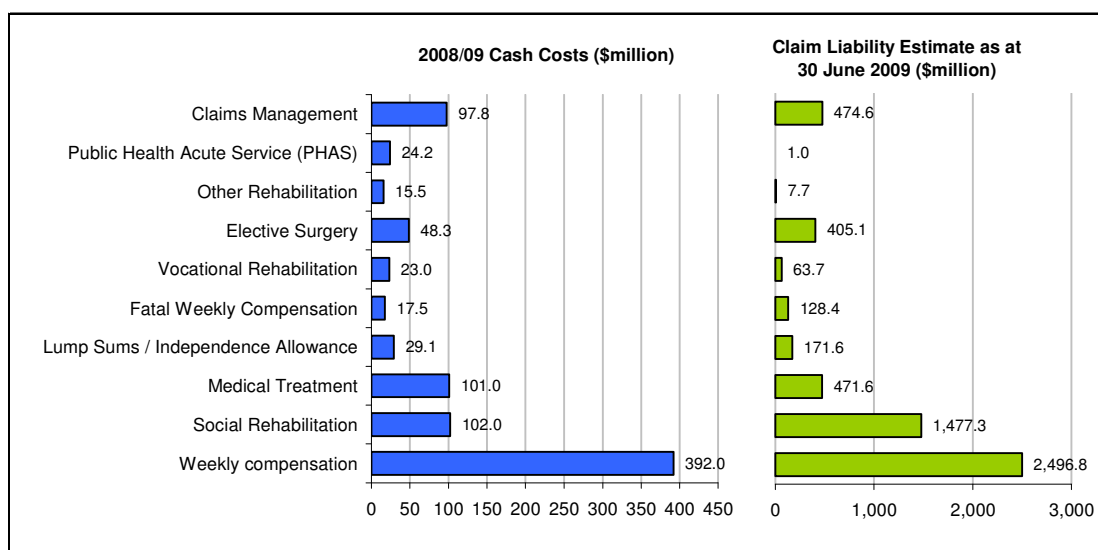
192 The proposed component of \$1.18 for this year's claims included a funding adjustment for pre-2010 claims. This means that ACC's proposed increase to the Work Account levy was in part because the Account was underfunded for claims from 1999-2010. In this sense, the \$1.18 proposed for this year's claims was also intended to cover accidents from prior years where current assets held are not sufficient to cover liabilities.

193 The graph below summarises the position of the Work and Residual Accounts as at 30 June 2009.



194 The majority of the Account's cash expenditure and outstanding claim liability is represented by weekly compensation costs. Social rehabilitation liabilities are still large in this Account however, and are driven by serious injury claims and hearing loss claims.

195 The graph below summarises the elements of cash expenditure and claims liability for the Work Account as at 30 June 2009. This graph helps to explain the difference between the cash costs for an Account and the elements of the OCL for that Account. The difference is that the OCL figure represents the expected future costs facing the Account, while cash costs reflect the amount of money actually spent by ACC in this Account in 2008/09.



196 In the chart above we can see that although the ACC spent roughly the same amount on social rehabilitation and medical treatment in 2008/09, it expects to spend more than three times more on social rehabilitation than medical treatment in the future for existing claims, demonstrating the financial importance of social rehabilitation costs.

### Claims growth

197 Claims for work related injuries have been decreasing since 2005. The chart below shows us that the number of claims made for work-related injuries has been decreasing at 3% per annum for the last five years. The declining number of claims has been driven by a reduction in the number of claims for work-related injuries in people aged 30-39. Injuries to the lower back are the predominate type of work-related injury followed by injuries to the fingers/thumb.

	2005	2006	2007	2008	2009
New Work Account claims	211,398	205,369	203,983	204,898	190,495
Claims that receive an entitlement in the Work Account	14.0%	14.2%	13.5%	13.3%	14.0%
Claims that receive weekly compensation	11.0%	11.0%	11.0%	10.7%	11.0%
Claims that go on to receive other entitlements	3.0%	3.2%	2.5%	2.6%	3.0%

198 The number of new weekly compensation claims from workers has dropped substantially since the mid-90s. The number of new injuries to the shoulder and lower back have stabilised after experiencing growth over the previous four years. The new 'other entitlement' claims are primarily for industrial hearing loss. There has been a stable trend of between 15 and 20 new serious injury claims each year – these are one of the types of claim that end up in the long-term claims pool.

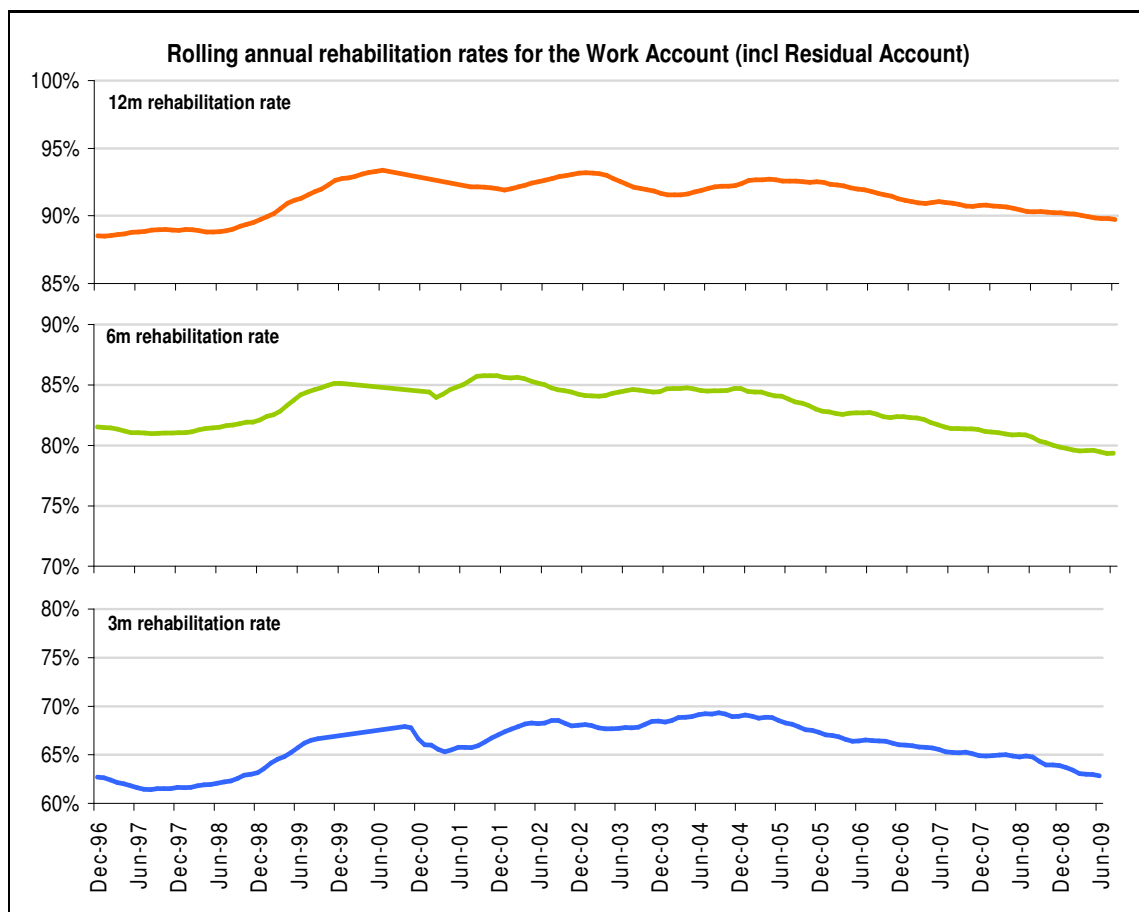
199 The number of fatal work injuries per year fluctuates between 40 and 60 (average of 53 over the last 7 years). The majority of fatal injuries are sustained in industrial work situations. Encouragingly, work-related fatal injuries occurring on the farm have halved over the last seven years.

### Rehabilitation rates

200 The following graphs plot the change in rehabilitation rates (a measure of return to work) for the combined Work Account since 1996.<sup>29</sup> These all show a deterioration in performance in the last five years.

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29 For the period of private delivery of the insurance and management of work injuries (1999-2000) the performance has been interpolated in the graphs.



## Claims costs

- 201 As part of their levy consultation late last year, ACC released figures on the expected average cost per entitlement claim in the Work Account for 2009/10. That cost was estimated to be \$24,217, with an estimated increase to \$25,333 for 2010/11.
- 202 It is important to note that the above average claim costs refer only to entitlement claims, and not all claims in the Work Account. However, we consider that entitlement claim costs should be the focus of ACC's efforts to improve the financial sustainability of the Scheme.
- 203 We commissioned work on the Accredited Employers Programme, which sought to detail the claims rehabilitation performance of employers who were allowed to utilise high levels of self-insurance. The researchers found that for non-entitlement claims the average cost for a standard Work Account claim was \$172 in 2009/10, while the average cost for an Accredited Employer claim was \$203. This supports our view that the costs of non-entitlement claims are marginal.<sup>30</sup>

<sup>30</sup> We note that this information is for claims of 48 months duration or less, whereas the figures given by ACC are for all Work Account entitlement claims, some of which may last for decades. Therefore they should not be directly compared.

204 For weekly compensation claims, the researchers found that the average cost for a standard Work Account claim was \$5,413 in 2009/10, while the average cost for an Accredited Employer claim was \$3,447. For other entitlement claims (eg, rehabilitation claims without a weekly compensation component) the average cost for a standard Work Account claim was \$934 in 2009/10, while the average cost for an Accredited Employer claim was \$1,244. For longer-term claims lasting 36 to 48 months the difference is similar: an average weekly compensation claim of that length is only \$25,421 for an Accredited Employer while it is \$41,604 for a standard ACC claim. This suggests that Accredited Employers may be more successful in achieving early rehabilitation, thus reducing average claim costs.

## The Motor Vehicle Account

205 The Motor Vehicle Account covers all personal injuries involving motor vehicles on public roads. It is funded from petrol excise duty and a levy collected with the motor vehicle relicensing fee.

### Financial performance

206 The Motor Vehicle Account has an unfunded liability of \$4.19 billion as at 30 June 2009. The levies for this Account were proposed to increase from \$287 in 2009/10 to \$417.28 in 2010/11. The actual levy set for the 2010/11 year was \$334.52 (this is an average across all vehicle types). Part of the reason for this decrease from the proposed rate was the changes made by the Accident Compensation Amendment Act 2010.

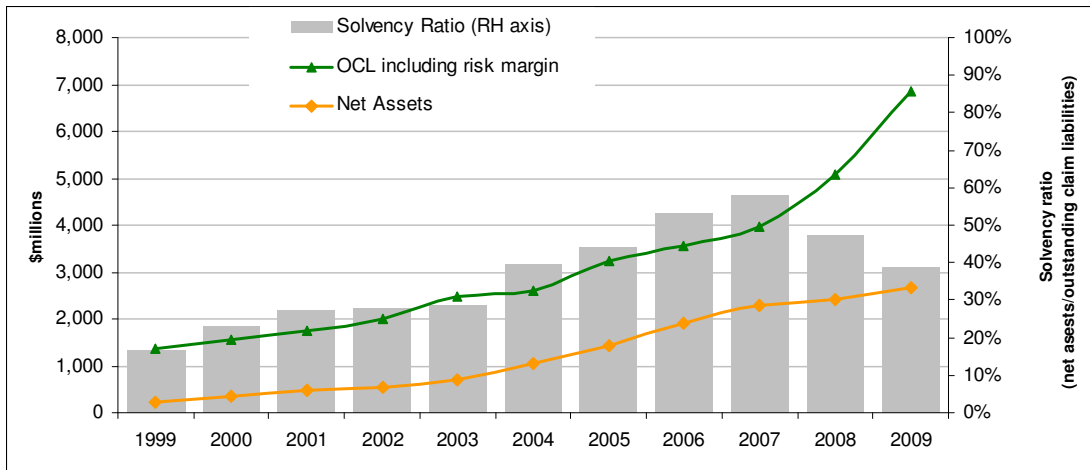
207 As with other Accounts, it is important to note the distinction between the component of the levy that is to fund pre-1999 claims and the portion for the cost (including the future costs) of this year's claims. For the originally proposed rate of \$417.28, the pre-1999 component was \$212.68, while the component for this year's claims was \$204.60.

208 The proposed component of \$204.60 for this year's claims included a funding adjustment for pre-2010 claims. This means that some of the reason for the proposed increase by ACC to the Motor Vehicle Account levy was because the Account was underfunded for claims from 1999-2010. In this sense, the \$204.60 proposed for this year's claims was also intended to cover accidents from prior years where current assets held are not sufficient to cover liabilities.

209 The graph below summarises the current position of the Account as at 30 June 2009.<sup>31</sup>

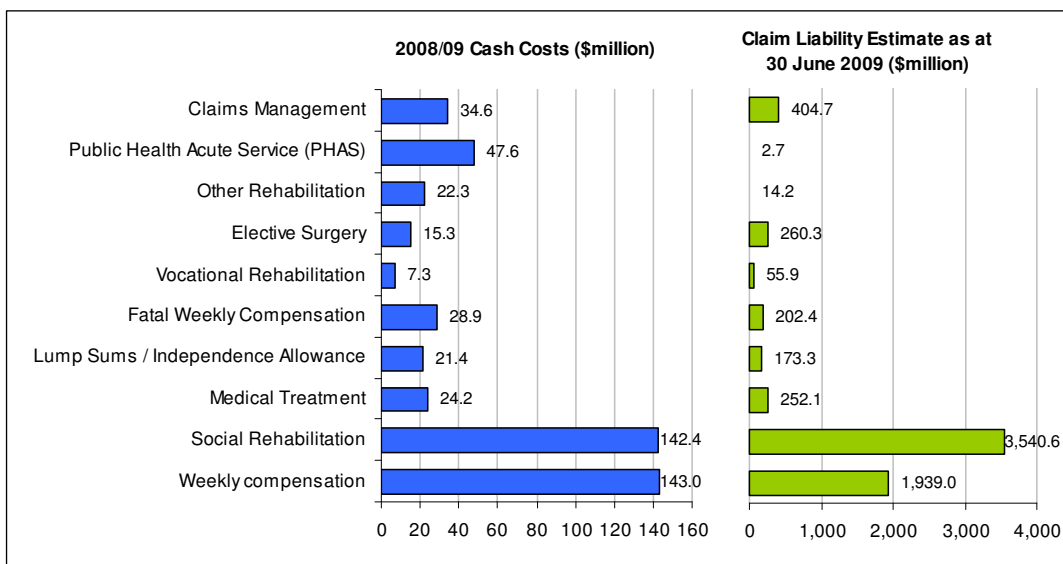
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<sup>31</sup> The Account was historically comprised of two parts: pre-1999 claims (claims from the period where pay-as-you-go applied) and the new claims fund. The graph combines both parts.



210 The jump in liabilities is driven by the factors described above, which are particularly acute in this Account where a large portion of the claims are for serious injuries. For instance, between 2008 and 2009 the estimated OCL for “Social Rehabilitation – Serious Injury” in this Account jumped from just over \$2 billion to just under \$3.5 billion.

211 The chart below compares the Account’s cash expenditure and outstanding claim liability, illustrating the difference between the cash costs for an Account and the elements of the OCL for that Account. The difference is that the OCL figure represents the expected future costs facing the Account, while the cash costs describe the money spent in 2008/09 only. In the chart below, for example, we can see that although ACC spent approximately the same amount on social rehabilitation and weekly compensation in 2008/09, it expects in the future to spend almost twice the amount of money on social rehabilitation than on weekly compensation for existing claims.



212 Among the different elements of claims liabilities for the Motor Vehicle Account, social rehabilitation and weekly compensation are the largest at \$3.541 billion and \$1.939 billion

respectively. What this chart is showing us is that, over the long-term, social rehabilitation costs represent the greatest pressure on the financial sustainability of the Account. This is due to the nature of motor vehicle crash injuries, which are more likely to be severe and require long-term care. Controlling these costs will have more impact on the Account's future liabilities than any other action.

### Claim frequency

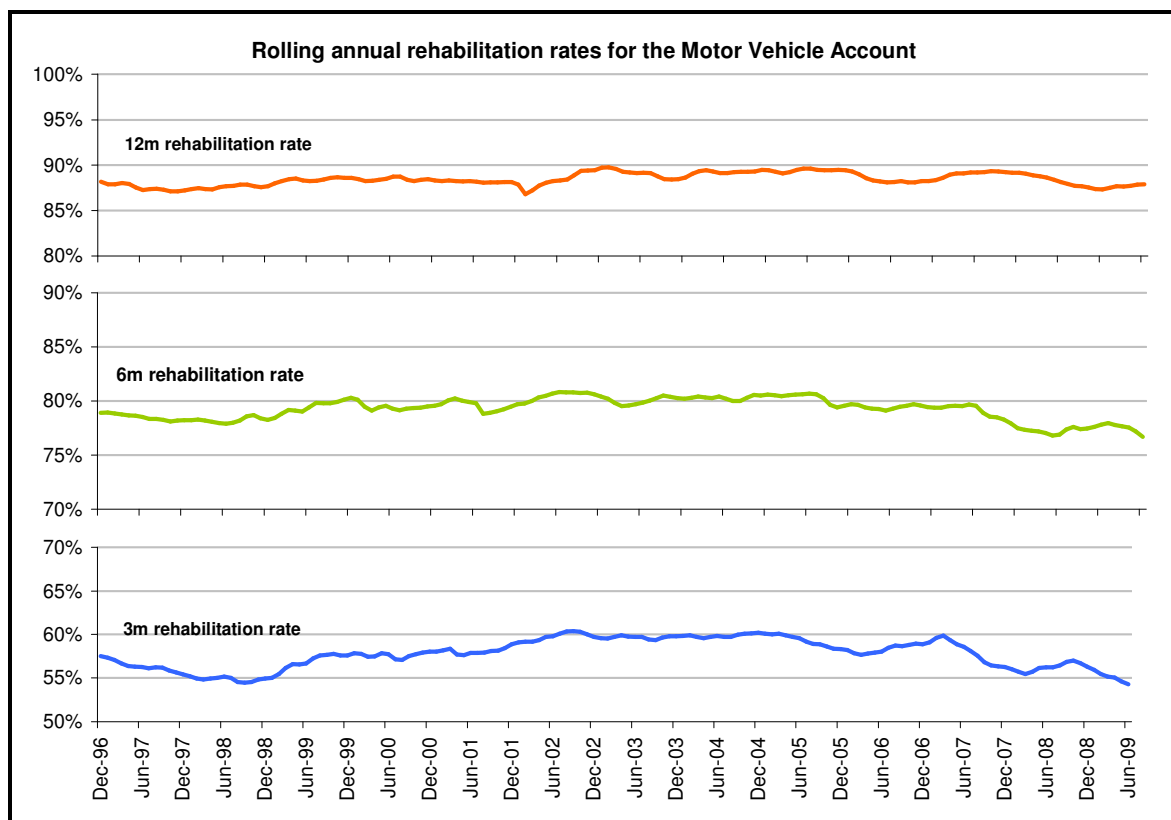
213 The number of Motor Vehicle Account claims has fallen recently. The claim rate per 100 people is around 10% lower than in the late 1990s. The table below illustrates the recent movement in new Motor Vehicle Account claims.

	2005	2006	2007	2008	2009
New Motor Vehicle Account claims	43,083	44,107	43,102	43,135	39,990
Claims that receive an entitlement in the Motor Vehicle Account	13.0%	13.5%	14.1%	14.1%	14.6%
Motor Vehicle Account claims that receive weekly compensation	9.6%	9.8%	10.2%	10.2%	10.1%
Motor Vehicle claims that go on to receive other entitlements	3.4%	3.7%	3.9%	3.9%	4.5%

214 A greater proportion of Motor Vehicle Account claims are entitlement claims compared to other Accounts, which is intuitive given the nature of motor vehicle injuries. 14-15% of Motor Vehicle Account claims turn into entitlement claims (compared to 13-14% of Work Account claims and 5-6% of non-work claims). Motorcycles make up 3% of the fleet but 21% of entitlement claims and 43-45% of serious injury claims arise from motor vehicle crashes.

### Claim duration

215 The following graphs show that gains in early rehabilitation (measured by the three month rehabilitation rate) were made in the Motor Vehicle Account in 2001-2002. Over this period there were also improvements in the 6 and 12 month rehabilitation rates. In the period 2005-2008 the Motor Vehicle Account declined in performance in early rehabilitation, seen in the falling 3 and 6 month rehabilitation rates. There was a short term improvement in the three month rehabilitation rate in 2006 and early 2007. From mid-2007 there has been a period of declining rehabilitation performance in the first six months of a claim's life, although recent performance has improved on this measure.



216 The table below provides the number of Motor Vehicle Account claims that have entered the long-term pool over the last 5 years. This table indicates to us that long-term claims in this Account have grown year-on-year between 2005 and 2009, and that this is likely a reflection of several factors, including the worsening rehabilitation rates in this Account.

	2005	2006	2007	2008	2009
Number of Motor Vehicle Account claims that have entered the long-term claims pool	-70	38	70	145	41

### Claim costs

217 As part of their levy consultation late last year, ACC released figures on the expected average cost per entitlement claim in the Motor Vehicle Account for 2009/10. That cost was estimated to be \$75,070, with an estimated increase to \$78,545 for 2010/11.

218 The above average claim costs refer only to entitlement claims and not to all claims in the Motor Vehicle Account. However, we consider that entitlement claim costs should be the focus of ACC's efforts to improve the financial sustainability of the Scheme. The average cost of other claims is likely to be very low.

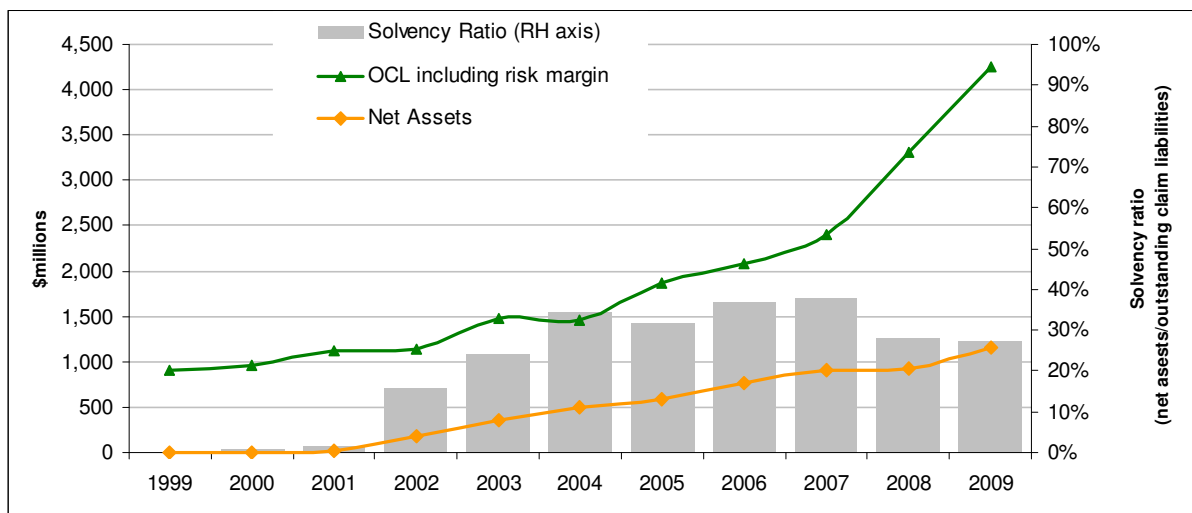
## Non-Earners' Account

219 The Non-Earners' Account covers injuries to people not in the paid workforce. This includes students, beneficiaries, older people, and children. Funding for this Account is from Government Appropriation.

### Financial performance

220 There are no levies for the Non-Earners' Account as it is funded from Crown Appropriation. The amount appropriated for 2009/10 was \$1.263 billion. This figure includes the portion given to the Treatment Injury Account. This appropriation represents an increase of \$30 million from the year before, bearing in mind that the \$1.233 billion appropriation for 2008/09 was \$300 million higher than budgeted for in 2008.

221 The gap between net assets and claims liability as at June 2009 was \$3.09 billion (this increases to \$3.583 billion if the non-earners' portion of the Treatment Injury Account is added). The graph below summarises the current position of the Account as at 31 March 2009.<sup>32</sup>



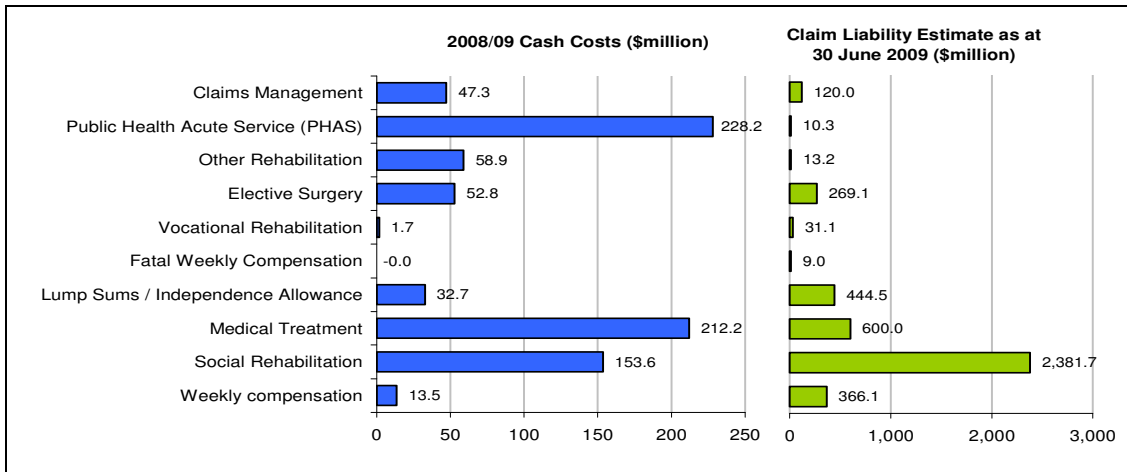
222 By comparison with the Motor Vehicle Account, Earners' Account, and Work Account, a relatively small proportion of the OCL of the Non-Earners' Account is driven by weekly compensation (\$366.1 million). But in common with these other Accounts, the social rehabilitation element of the OCL for the Non-Earner's Account has increased dramatically in the last five years and now totals \$2.382 billion.

223 The growth of the social rehabilitation element of the OCL of this Account is of particular concern. For serious injuries the estimated liabilities for social rehabilitation in this

<sup>32</sup> It should be noted that the Non-Earners' Account is practically divided into two sections: a pay-as-you-go section for pre-2001 claims, and a fully funded section for post-2001 claims. The post-2001 claims portion is nearly fully funded, with an estimated solvency ratio of 97% forecast for 30 June 2010.

Account have increased from roughly \$600 million in 2004 to nearly \$1 billion in 2006, and finally to roughly \$2.3 billion in 2009. This is unsustainable.

224 In the chart below we can see that although ACC spent more on medical treatment than on social rehabilitation and weekly compensation in 2008/09, it expects in the future to spend nearly quadruple the amount of money on social rehabilitation as on medical treatment for existing claims. This indicates to us that future social rehabilitation costs are a real concern, and that they last well into the future.



225 Around 46% of the expenditure on social rehabilitation in the Non-Earners' Account is for serious injury claimants.

### Claim frequency

226 There has been a significant increase in the number of minor (medical fee only) claims since 2005 in this Account, likely due to initiatives to improve access to the Scheme over this period.

227 The chart below summarises the percentage of Non-Earners' Account claims that go on to become entitlement claims. We note that the relatively low number of people entitled to weekly compensation in this Account means that the percentage of entitlement claims tends to be low. However, the \$2.3 billion in outstanding liabilities for social rehabilitation indicates that, notwithstanding the relatively low percentage of entitlement claims, long-term claims in this Account pose large financial burdens for the Scheme and should be addressed.

	2005	2006	2007	2008	2009
New Non-Earners' Account claims	781,414	815,822	835,653	836,693	847,852
Claims that receive an entitlement in the Non-Earners' Account	2.8%	3.1%	3.1%	3.1%	3.2%
Non-Earners' Account claims that receive weekly compensation	0.0%	0.1%	0.1%	0.1%	0.0%

## Claim duration

228 Duration results for the Non-Earners' Account are not available because of the small number of non-earners receiving weekly compensation. However, the table below shows the net increase in the number of Non-Earners' Account claims in the long-term pool over the last 5 years. Since this table shows the net increase in long-term claims each year, it indicates that long-term claims in this Account are growing year-on-year. This is likely a reflection of worsening rehabilitation rates in this Account for the period under review. This situation is likely to be enduring if not addressed, given the present demographics of an ageing population.

	2005	2006	2007	2008	2009
Net increase in the number of Non-Earners' Account claims in the long-term claims pool	39	32	17	36	35

## Claim costs

229 ACC does not publish information on the Non-Earners' Account when releasing its levy consultation documents because changes to this Account do not require public consultation. However, estimates of costs per claim in the Non-Earners' Account have been generated for the Department of Labour. On an undiscounted basis, these estimates appear in the table below.

	2006/07	2007/08	2008/09	2009/10	2010/11
Undiscounted cost per claim in the Non-Earners' Account per annum	\$1,196	\$1,249	\$1,387	\$1,411	\$1,370

230 Using ACC data on total numbers of active entitlement claims (both weekly compensation and non-weekly compensation), we can generate an estimate of the total cost per entitlement claim in the Non-Earners' Account by dividing the total Account expenditure on rehabilitation and compensation by that number of active claims. This process yields the following estimates.

	2006	2007	2008	2009
Estimated cost per active entitlement claim in the Non-Earners' Account per annum	\$92,815	\$84,740	\$90,164	\$117,623

231 In the Non-Earners' Account the following amounts were paid over the last five years for independence allowances, lump sums, and death benefits (these entitlements are available for claimants with fatal or very serious injuries).

\$ (000)	2005	2006	2007	2008	2009
Independence Allowance	17,320	17,757	17,148	17,814	29,074
Lump sums	3,028	3,612	16,838	7,173	3,605
Death benefits	2,844	3,738	4,916	5,942	6,709

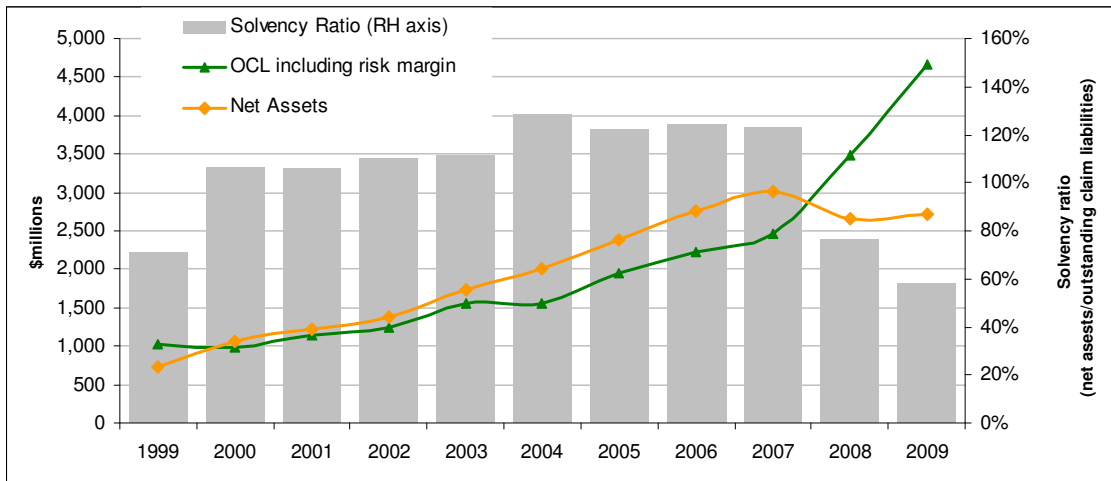
- 232 There was a large jump in Independence Allowance payments from 2008 to 2009 and in lump sum payments for 2007 and 2008. We understand that the increase in Independence Allowance payments is due to a five-year cycle of capitalisation that is allowed by a law passed in 2003. This means that every five years an ACC claimant who qualifies can have an Independence Allowance paid up-front for the entire five year period.
- 233 The increase in lump sum payments result from a 2006 Court of Appeal decision on claimants suffering the effects of work-related exposure to asbestos. This decision meant that ACC was liable to pay lump sums to these claimants. Further review by ACC indicated that, by law, claims between 2002 and 2005 (when legislation was amended) should be paid from the Non-Earners' Account rather than from the Residual Claims Account because the claimants were non-earners at the time of their injury.

## Earners' Account

- 234 This Account covers non-work injuries (including at home, and during sport and recreation) to earners. This Account is funded from earners' levies (paid through PAYE) plus self-employed levies based on earnings.

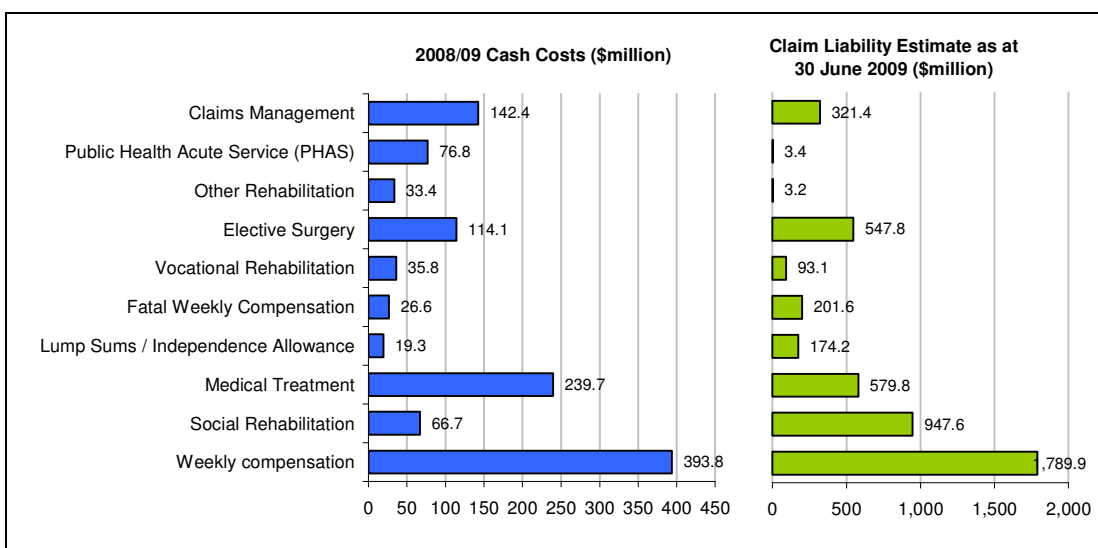
## Financial performance

- 235 The Earners' Account had an unfunded liability of \$1.95 billion at 30 June 2009. The levies for this Account (all exclusive of GST) were proposed by the ACC to increase from \$1.51 per \$100 wages in 2009/10 to \$2.40 in 2010/11. The actual rate set for 2010/11 was \$1.78 per \$100 wages. Part of the reason for this decrease from the proposed rate was the changes made by the Accident Compensation Amendment Act 2010.
- 236 The total Earners' levy has two components, one for 1992-1999 claims and one for the cost of this year's claims. For the 2010/11 levy year, 5.33 cents is for 1992-1999 claims and \$1.7245 is for this year's claims. Pre-1992 non-work claims by earners are covered by the residual portion of the Work Account.
- 237 The proposed component of \$1.7245 for this year's claims included a funding adjustment for pre-2010 claims. This means that some of the reason for the increase proposed by ACC for the Earners' Account levy was because the Account was underfunded for claims from 1999-2010. In this sense the \$1.7245 proposed for this year's claims was also intended to cover accidents from prior years where current assets held are not sufficient to cover liabilities.
- 238 The graph below summarises the current position of the Account as at 30 June 2009.



239 The Account historically comprised two funds: claims incurred from 1992-1999 (claims from the period where “pay-as-you-go” funding basis was applied) and the new claim fund. The 1992-1999 claims are to be fully funded by 2019, while the post-1999 claims are to be fully funded each year. The Earners’ Account was fully funded up to 2007, and the recent expansion in the OCL has had a particularly large impact on this Account.

240 In the chart below, for example, we can see that although ACC spent much more on medical treatment than on social rehabilitation in 2008/09, it expects to spend almost twice the amount of money in the future on social rehabilitation than medical treatment for today’s claims. In the long-term, it is weekly compensation payments that pose the greatest threat to the financial health of this Account. Also, although medical treatment costs are large on a year-to-year basis, they are not as problematic as social rehabilitation costs over the long-term.



241 Many Earners’ Account injuries are minor. As a result, the proportion of costs reflected in medical treatment is relatively high, although as with the Motor Vehicle Account weekly

compensation and social rehabilitation remain the largest elements of ongoing liability in dollar terms, at \$1.790 billion and \$948 million respectively.

### Claim frequency

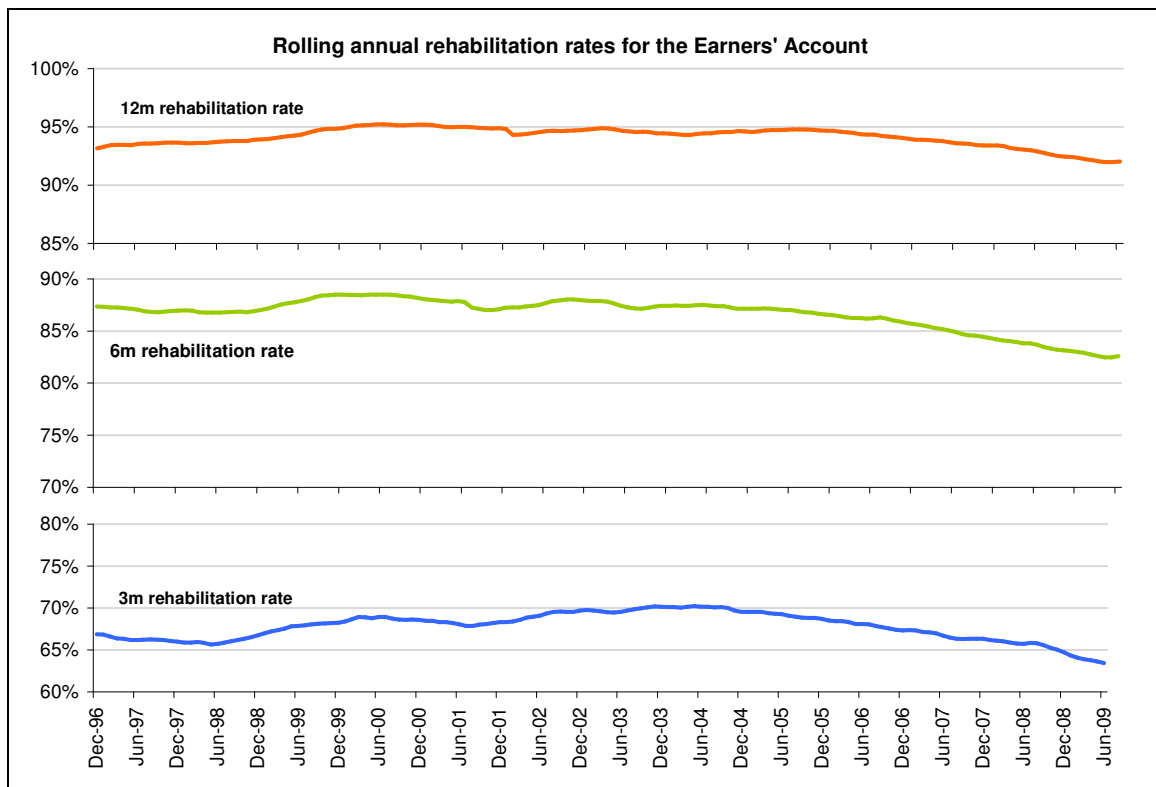
- 242 The Earners' Account is the single largest source of new weekly compensation claims for ACC. This suggests that workers are more likely to be injured away from work than when they are actually working. Unlike the Work Account the volume of new weekly compensation claims has continued to rise until 2008/09. Entitlement claims (defined as the claims that incur charges beyond initial health practitioner visits) have also grown. The 2008/09 entitlement claim rate (the rate of claims that end in payments of entitlements) is 36% higher than 2000/01. We do note that 2009/10 entitlement claim numbers appear to be declining from the previous year's level.
- 243 Two possible explanations for the increase in claim frequency are that there has been an increase in the workforce and a higher propensity to claim for non-work injuries. The reasons behind the increased claim rate remain unknown. However, it is postulated by ACC that a reduction in the difficulty in dealing with ACC, lower co-payments for services, low unemployment, a national skill deficit, and blurring of the boundaries between health and injury have contributed to the growth in claims.
- 244 The number of new serious injury claims for the Earners' Account has been growing at around 8% per annum over the last 15 years. Currently there are between 30 and 35 new serious injury claims each year. The frequency of Earners' Account claims ending as entitlement claims is outlined below.

	2005	2006	2007	2008	2009
New Earners' Account claims	561,866	612,097	662,650	662,668	665,070
Claims that receive an entitlement in the Earners' Account	8.3%	8.5%	8.5%	8.5%	8.6%
Earners' Account claims that receive weekly compensation	6.5%	6.5%	6.5%	6.5%	6.4%
Earners' claims that go on to receive other entitlements	1.8%	1.9%	2.0%	2.0%	2.2%

- 245 The number of fatal injuries per year was steady at 200-220 for a number of years. However in 2006/07 the number of fatal injuries resulting in a claim rose to more than 250. This increase may be due to a greater awareness of being able to lodge a claim with ACC for a non-work fatal injury rather than an increase in the number of fatalities around the home or from sporting/recreational activities.

### Claim duration

- 246 The rolling average rehabilitation rates for the Earners' Account are graphed below.



247 Although the changes appear to be small these have a significant impact when the total volume of claims is taken into account. For example the 3% decline in the three month rehabilitation rates from 2007 to 2009 means that 1,400 more people will require more than three months of income replacement in 2009 than would have occurred in 2007.

248 Because the Earners' Account provides the majority of the new weekly compensation claim payments, the rehabilitation rates in this Account have a significant impact on the overall Scheme rehabilitation rates.

249 The table below provides the net increase in Earners' Account claims in the long-term pool over the last 5 years. This table indicates to us that long-term claims in this Account are growing year-on-year, and that this is likely a reflection of the worsening rehabilitation rates in this Account.

	2005	2006	2007	2008	2009
Net number of Earners' Account claims in the long-term claims pool	-37	233	396	546	488

### Claim costs

250 As part of their levy consultation late last year, ACC released figures on the expected average cost per entitlement claim in the Earners' Account for 2009/10. That cost was estimated to be \$22,614, and estimated to increase to \$23,380 for 2010/11. These average claim costs refer only to entitlement claims, and not all claims in the Earners' Account. However, the Steering Group believes that entitlement claim costs should be the

focus of ACC's efforts to improve the financial sustainability of the Scheme. The average cost of other claims is likely to be very low.

251 The estimated cost of each entitlement claim, and the increase of estimates by 3.4% for 2010/11, indicate to the Steering Group that work should be done on reducing or at least stabilising the average cost of entitlement claims in the Earners' Account.

252 We have also received information on the costs for some entitlements in the Earners' Account for the last several years, as described in the chart below. This demonstrates that ACC's costs are increasing in the Earners' Account across all entitlements, not just social rehabilitation or weekly compensation.

\$ (000)	2005	2006	2007	2008	2009
Independence Allowance	5,415	5,974	6,279	6,725	12,831
Lump sums	3,079	3,224	5,214	6,699	6,456
Death benefits	14,055	17,273	21,291	26,905	33,485

253 There has been a steady increase in the growth of death benefits in this Account. This is likely driven by the overall increase of fatal injuries reported to the Scheme in recent years. It is possible that in the past the number of fatal claims was under-reported, and public education campaigns in recent years may have led to increased awareness of this entitlement.

254 The explanation of the drivers for the increase in Independence Allowances is likely to be similar to the explanation for the increase in the Non-Earners' Account, namely that there is a period of re-capitalisation that occurs every five years for this entitlement.

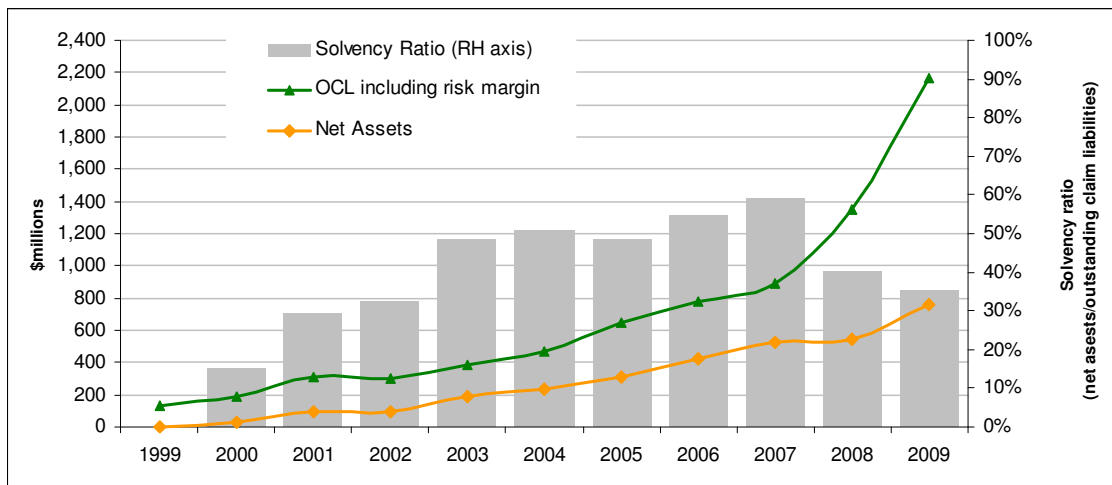
## Treatment Injury Account

255 The Treatment Injury Account provides cover for treatment injuries that occur as an unexpected consequence of medical treatment. Cover was increased from pure medical misadventure to the wider treatment injury regime from 1 July 2005. This Account excludes treatment injuries subsequent to medical treatment for a work-related injury, which are covered by the Work Account.

## Financial performance

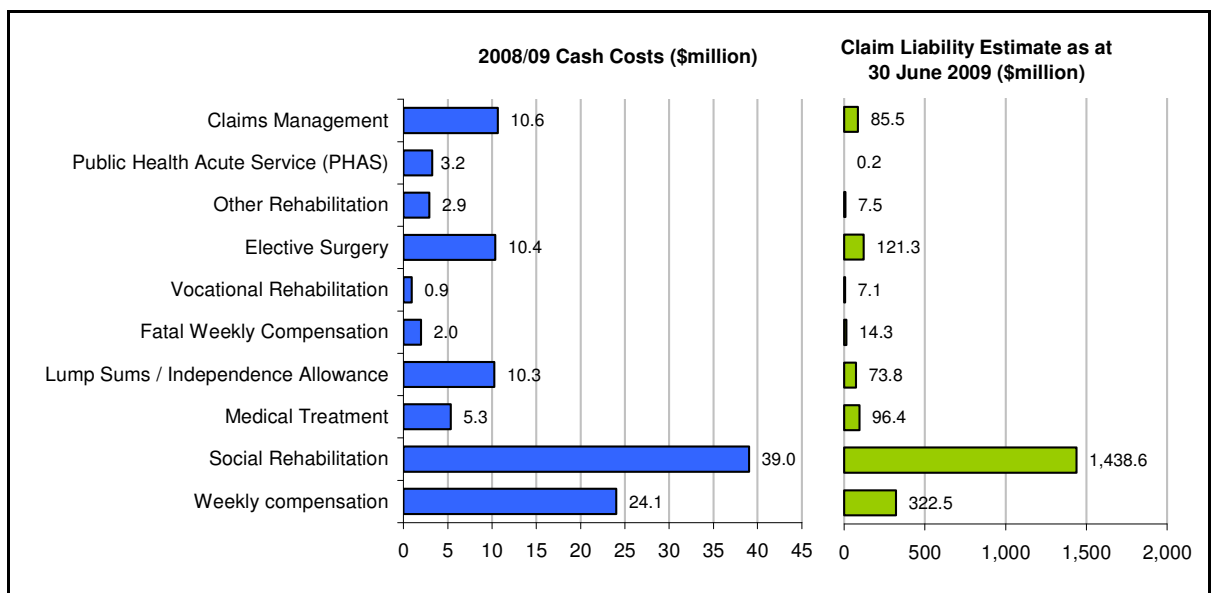
256 The Treatment Injury Account is funded by employees via their earner levies (for injuries to earners) and a Government contribution (for injuries to non-earners). The Treatment Injury Account had unfunded liabilities of \$1.41 billion at 30 June 2009. The graph below summarises the current position of the Account as at 31 March 2009. For the financial year ending 30 June 2011, \$231 million in funding is planned to come from the Non-

Earners' Account (around 70% of the total Treatment Injury Account revenue), while \$97.3 million is planned to come from the Earners' Account (around 30% of revenue).<sup>33</sup>



257 As with the Motor Vehicle Account, Earners' Account, Work Account, and Non-Earners' Account, social rehabilitation remains one of the largest elements of outstanding liabilities in dollar terms, at \$1.439 billion.

258 The chart below helps to explain the difference between the cash costs for an Account and the elements of the OCL for that Account. The difference is that the OCL figure represents the expected future costs facing the Account, while the cash costs describe only the money spent in 2008/09. Unlike other Accounts, the chart below shows us that for the Treatment Injury Account social rehabilitation is the main cash cost year-to-year as well as the main expected future cost.



<sup>33</sup> There is a component of the Treatment Injury Account which consists of non-earner claims from before 2001, which as noted earlier are funded on a pay-as-you-go basis.

259 Cash expenditure for social rehabilitation and weekly compensation has risen dramatically. Social rehabilitation cash costs alone have gone from \$2 million in 2004 to \$39 million in 2009.

### Claim frequency

260 The table below shows the annual new claim volumes and the growth in entitlement claims since 2005.

	2005	2006	2007	2008	2009
New Treatment Injury Account claims	2,563	3,603	4,647	5,073	5,472
Claims that receive an entitlement in the Treatment Injury Account	28.7%	31.4%	33.1%	30.3%	34.9%
Treatment Injury Account claims that receive weekly compensation	15.5%	10.4%	12.9%	11.8%	12.3%
Treatment Injury claims that go on to receive other entitlements	13.2%	21.1%	20.2%	18.5%	22.6%

### Claim duration

261 Information on rehabilitation rates for this Account is not available. However, the table below provides the net increase in Treatment Injury Account claims in the long-term pool over the last 5 years.

	2005	2006	2007	2008	2009
Number of Treatment Injury Account claims that have entered the long-term claims pool	6	31	6	48	52

### Claim costs

262 Using data on total numbers of active entitlement claims from ACC (both weekly compensation and non-weekly compensation) we can generate an estimate of the total cost per entitlement claim in the Treatment Injury Account by dividing the total Account expenditure on rehabilitation and compensation by the number of active claims. That process yields the following estimates.

	2006	2007	2008	2009
Estimated cost per active entitlement claim in the Treatment Injury Account per annum	\$52,967	\$56,294	\$55,852	\$67,130

263 The trend toward increasing claim costs is evident in the payment of Independence Allowances, lump sums, and death benefits. In the Treatment Injury Account the following amounts were paid for those entitlements over the last five years:

\$ (000)	2005	2006	2007	2008	2009
Independence Allowance	1,804	1,753	1,975	2,137	3,824
Lump sums	2,555	2,792	4,385	4,897	6,438
Death benefits	1,747	1,429	1,932	2,952	2,932

## Injury rates and injury prevention

- 264 A successful injury prevention strategy is one of the most effective ways of improving the financial position of the Scheme. Obviously, the fewer people who are injured, the less liability faced by the Scheme, quite apart from the social benefits of fewer accidents.
- 265 It is unknown exactly how much money is spent on injury prevention in New Zealand per year, although ACC reports a figure of \$39 million for their administrative costs in the 2008-2009 year. Other expenditures across government contribute to injury reduction through the New Zealand Injury Prevention Strategy (for which ACC provides the secretariat and administers the strategy). These range from Department of Labour expenditure on occupational health and safety, to transport sector spending on safer roads, and Ministry of Health public health initiatives. Estimating a return on investment is therefore difficult.
- 266 It is also difficult to estimate how much money should be spent on injury prevention because it is hard to attribute changes in the rate of injury to specific injury prevention expenditures. Linking specific causal factors to the increase or decrease in injury rates is notoriously difficult, and this should be borne in mind when examining the injury statistics below.
- 267 In its 2009 Annual Report, ACC informs us that the rate of injuries has been increasing in recent years. The rate of serious non-fatal injuries among the entire population is showing an increase, up from 211.92 per 100,000 person years at risk in 2005 to 218.10 per 100,000 person years at risk in 2007.
- 268 The ACC has focused on a range of programmes to provide information about high-risk activities, and claims some success for these activities (such as with drownings and motor vehicle crashes). That success is perhaps most easily demonstrated where there is co-operation with enforcement agencies on specific initiatives (driving speeds, fencing of swimming pools). In other areas the effectiveness of the ACC's efforts, and the value for money from its investment in information about the risk of injury, will always be unclear.
- 269 The Steering Group has formed the view that accident prevention is primarily a matter of individual decisions and investments in safety. Thus we consider that a greater focus on incentives for people to take care is likely to have a greater impact on accident prevention than a focus on information programmes. In this respect, the very limited amount of risk and experience rating used in the ACC Scheme outside of the Accredited Employer Programme is a major barrier to improving our national injury record. We consider these issues in greater detail in section 8 below.
- 270 Comparing injury rates across different countries is notoriously difficult because different jurisdictions use different methods for categorising and recording accidents. Also, the structure of different schemes may provide stronger or weaker incentives to report

injuries as originating with accidents. The University of Otago has recently released a report entitled *International Comparisons of Injury* that compares the rates of fatal injuries across several Western countries. The report does not attempt comparisons of non-fatal injuries as it was agreed methodological issues would make such comparisons very difficult.

- 271 For the period 2000-2002 the report concludes that New Zealand's fatal injury rates per 100,000 people were relatively high (40.5), 75% higher than England and Wales (23.2), but behind the USA (50.0). The report notes that interpretation of these figures is complex. The definition of "injury" leading to death was not uniform across countries. The determinants of injury rates also differ across countries. For example, falls account for a large number of fatal injuries for those over 65 years old. But, in this group, deaths are often due to late complications of the fall and so deaths may not be attributed to the fall itself, but rather from complications that emerge later, like pneumonia. So a comparison of fatal fall rates across countries will be difficult because there may be differing methods of recording the cause of death in various countries.
- 272 The study attempted to focus on relative differences in exposure to risk, and the use of known safety features and behaviours in the relevant countries compared to New Zealand. It found that:
- i "New Zealand has a relatively high (per capita) fatal crash rate compared with similar countries, using available information. It appears that this is partly due to the high level of vehicle use in New Zealand. Reductions in road traffic deaths could come from both reducing driving exposure and from research into differences in hazard exposure and intervention levels between New Zealand and countries with lower road traffic mortality.
  - ii New Zealand's overall homicide rate is reported to be the same or slightly higher than other similar countries with the exception of the United States. The child homicide rate appears to be higher than some countries we compare ourselves to (eg, Spain, Italy, and Ireland) but similar to the rest of Europe, Australia, and Canada. However, there is substantial uncertainty about the international comparability of homicide data and the availability of guns appears to account for the difference seen with the US.
  - iii In New Zealand, mortality from suicide and intentional self-inflicted injury is higher than for any other major injury cause, including road traffic crashes... The rates peaked in the 1995-7 period and have declined since, in common with other similar countries. New Zealand's suicide rate is fairly high compared with other similar countries using the best available information.
  - iv The mortality rate from drowning in New Zealand appears high compared with other similar countries, but the comparisons are likely to be unreliable. New Zealand has a higher rate of male adult drowning deaths compared with toddler deaths than many other countries, including Australia. This may relate to higher exposure to risk for men in New Zealand through geography, occupation, and recreation, and lower risk to toddlers through fewer home swimming pools."

273 The Steering Group believes that the Otago study points out some particular areas where New Zealand could improve its injury prevention performance – notably motor vehicle crashes and drownings. While environmental factors may limit the options available to combat injury rates in these areas, the ACC and society as a whole should continue to seek to improve its injury prevention performance in these areas.

## Conclusion

274 Our analysis of the components of the increase in the outstanding claims liability between 2004 and 2009 may be summarised as follows:

- Only 27% of the \$14.4 billion increase was anticipated by the actuarial valuation in 2004.
- Another 33% of the increase was outside the control of management, being due to changes in accounting standards, economic factors and legislation. These included:
  - changes to accounting standards, primarily the adoption of the 75% risk margin (see section 5)
  - changes to the discount rate used in the valuation (as risk free rates fell during the global financial crisis).
  - changes to the scope of entitlements resulting from legislation and court decisions.
- The remaining 40 percent of the increase (\$5.8 billion) was the unanticipated cost increase for social rehabilitation, weekly compensation and medical costs. The drivers for this increase in costs were: the increasing number of new claims, the lengthening duration of claims, and increases in claim costs above inflation. These factors were, to a significant extent, within the power of the ACC to manage (inflation in medical treatment costs perhaps being an exception).
- The contribution of new programmes and legislation was significant in financial terms (\$600 million) but a minor proportion of the overall increase in outstanding claims liability.
- Social rehabilitation is overwhelmingly the most important single contributor to the increase in outstanding claims liability, representing 32% of the total, and 22% of the \$5.8 billion unanticipated increase in liabilities.

275 Only the non-residual portion of the Work Account and the post-2001 component of the Non-Earners' Account are fully funded, which means that for the foreseeable future levies or general taxation will be required to fully fund the historic shortfalls that currently exist in other Accounts.

276 Rehabilitation rates deteriorated across the Scheme in all Accounts over the period 2004 - 2009. This had large impacts on ACC's bottom line as it means claimants are staying on the Scheme longer and costing more than was expected when levies were set in the past. The recent reversal in this trend under the current Board and management of ACC,

together with the relatively high rehabilitation rates achieved from 2002 – 2003 demonstrate the very substantial benefits that can be obtained in the scheme from a strong focus on effective and efficient rehabilitation programmes.

- 277 In our view, the successful management of long-term claims provides ACC with the greatest ability to reform its financial position and achieve financial sustainability. This is likely to involve a combination of earlier and more effective treatment and rehabilitation interventions in the first three months following the injury, a focus on rehabilitation performance targets at the ACC, and a move away from the entitlement culture that has allowed the number of claimants to expand in the recent past.
- 278 Long-term claims numbers are very small when compared with the total numbers of claims to the Scheme, but they comprise the bulk of the cost to the Scheme. Social rehabilitation and weekly compensation costs are the key drivers of the cost of these long-term claims.
- 279 In the absence of competition we do not possess good benchmarks to judge ACC's management of overall Scheme performance. However, it is clear that the performance of the Scheme has deteriorated significantly since 2004 on all important measures, and in particular on claims rates, claims costs, rehabilitation rates and Scheme solvency. It is also clear that a significant portion of this deterioration in performance has occurred in factors that ACC can actively manage. The government should therefore address the need to establish benchmarks for dramatically improved performance by the ACC based on the best performance achieved in the past.
- 280 Accident prevention is primarily a matter of individual decisions and investments in safety. The Steering Group believes that an increased focus on incentives for people to take care is likely to have a greater impact on accident prevention than a focus on information programmes.

**Recommendation:** Require that the ACC achieves a greater focus on improving return to work rates, and in particular, on raising return to work rates in the first three months following the accident. This should include setting targets for rehabilitation based on the best performance of the past, holding ACC management strictly accountable for the achievement of these targets, and the use of private sector support for rehabilitation and claims management wherever it is efficient to do so.

## 6 Māori experience of ACC and the Scheme

### Introduction

- 281 The previous section analysed the performance of ACC and the Scheme from a general population perspective. This section discusses the implications of socioeconomic, demographic, and regional factors by considering the experience of Māori with ACC and the Scheme.
- 282 Disparities in Māori access to and utilisation of primary healthcare represent a significant social policy challenge for New Zealand. Despite recent efforts by the ACC to mobilise Māori community channels to support dissemination of knowledge about the ACC Scheme, and the use of primary health services gateways to treatment and rehabilitation supported and funded by the ACC, disparities continue to exist between Māori and non-Māori utilisation of the ACC Scheme.
- 283 This section considers the evidence on Māori accident rates and claims experience with the ACC. It also uses research commissioned by the Steering Group to outline Māori views of the ACC Scheme and of the services provided to Māori by the ACC. Finally, it provides an outline of Māori views about the potential introduction of competitive private delivery of accident compensation services.

### Māori participation in and rates of ACC claims

- 284 Māori do not access the ACC Scheme at the same rate as the rest of the population. While representing 14.6% of the population (at Census night 2006), Māori lodge only 11.55% of all ACC claims. This is consistent with the lower usage of health services by Māori, particularly the primary care gateway to the ACC.
- 285 Māori have a particularly low rate of claims in the Earners' Account, possibly indicating a lack of knowledge of the coverage ACC offers (ie, coverage for injuries sustained outside the workplace). The Māori rate of claiming in the Earners' Account is 9.47% while Statistics NZ data indicate that 11.47% of the working population is Māori.<sup>34</sup>
- 286 Māori are, however, strongly over-represented in serious injury claims and in hospitalisation for serious injury. Māori are a population at high risk of injury, with 30-50 percent higher injury hospitalisation rates, 33 percent more head / traumatic brain injuries, and 200-300 percent more spinal cord injuries. Sixty percent of work-related serious injury claims from Māori occur in three industry groups: agriculture, fishing, and forestry (30%); construction (18.3%); and manufacturing (11.7%). Sixty percent of work-related non-serious injury claims from Māori also come from these three industries.

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34 Household Labour Force Survey, June 2009.

Serious injury claims involving Māori	
Account	Percentage Māori claimants
Work Account	13.19%
Non-Earners Account	24.93%
Earners Account	12.15%
Motor Vehicle	22.18%

- 287 Among claimants aged 45 and older, Māori are twice as likely to receive weekly compensation as non-Māori. Among claimants under 45 years of age the diversion in the conversion rate to weekly compensation is less marked, but Māori are still more than 20 percent more likely to draw weekly compensation than non-Māori. The increase in the disparity in conversion rates with age is notable because for non-Māori older age is associated with a lower probability of conversion to weekly compensation, whereas for Māori the opposite is true. It is likely that these patterns are influenced by the higher representation of Māori in heavy manual work. Heavy work requires higher levels of fitness and is most common in industries where there are fewer opportunities for lighter alternative duties.
- 288 The Māori population is younger on average than the population of New Zealand as a whole and will make up an increasing proportion of the workforce in the future. This means that unless Māori injury rates are addressed, national injury rates will continue to rise, especially if Māori do not move from the industries they are currently concentrated in
- 289 Māori are less likely to receive home support services (primarily attendant care, home support and childcare services) than non-Māori where injuries are not serious. For serious injuries, the evidence is that Māori receive the same level of home support services as non-Māori. Māori are also slightly less likely to receive elective surgery as part of an ACC claim than are non-Māori.
- 290 ACC data therefore confirm that there are differences between Māori and non-Māori in the uptake of ACC entitlements. These differences appear to be highly correlated with differences in the age structure of the populations, and differences in the industries and types of work in which Māori are over-represented. However the data also suggest that there are differences in the way in which Māori and non-Māori claimants interact with ACC that cannot be explained by the age and work profiles of the two populations, most notably the lower total volume of claims made by Māori. Māori are less likely to lodge claims for less serious injuries. Māori also have a very low rate of claiming social and vocational rehabilitation, which may be because this aspect of the ACC Scheme favours better informed claimants who ask for services.

## Māori views of ACC

- 291 The Steering Group commissioned research on Māori perceptions of the ACC Scheme and the delivery of services by the ACC. The results of this research, conducted through interviews / hui with 100 individuals, are reported below.
- 292 Māori respondents were virtually unanimous on the need for an accident insurance scheme, on the benefits of a compulsory, no-fault programme, and on the value of straightforward, automatic claims processes and treatment of acute injuries. Furthermore, Māori clearly valued the ACC Scheme, particularly in areas like the Far North where rurality and isolation are major issues for the community, along with high levels of unemployment or transient employment. Māori appreciate that in the absence of such a scheme many in the community would have no recourse if they were injured.
- 293 Māori value a scheme that is “fair” to all. The fairness principle is consistent with the Māori tikanga (code, rule, custom, habit) of tika (fair, just, straight, true). Fairness requires that attention be paid to the physical, emotional, spiritual, social, and cultural needs of its target populations. Māori taking part in the study commissioned by the Steering Group were explicit in their belief that in order for the ACC Scheme (in whatever future form it takes) to be fair, it must address their needs and achieve equitable outcomes for Māori.
- 294 Māori overall are uncertain of the services and benefits to which they are entitled, demonstrating the need for more tailored communications for Māori. There is international research evidence that when programmes to improve health are focused on the average consumer, who is usually a member of the majority culture, levels of access or quality of care for the mainstream community may rise but those for under-served groups generally lag behind, thereby widening disparities. By contrast, if communications are customised and directed at the groups who are most disenfranchised, then they, along with the mainstream population, benefit from the programmes, thereby reducing disparities as well as improving the status of everyone. Tailored communication is therefore preferable when attempting new public health initiatives, along with other potential strategies designed to improve outcomes, and thus should be part of any strategy to change or improve the ACC Scheme.
- 295 Most Māori interviewed supported the compulsory nature of the Scheme. Many contended that unless the ACC Scheme is compulsory, many Māori (and particularly those with limited income) will opt to spend their money elsewhere, leaving themselves vulnerable in the event of an injury or accident. Enthusiasm for a compulsory scheme comes from several considerations, including the unpredictability of trauma and the belief that it is an aspect of the social contract to provide care to those who might otherwise not be able to afford it. This last idea is an expression of the Māori value, manaakitanga.
- 296 There is widespread awareness that Māori are not as well served by ACC as non-Māori, and this impacts upon their likelihood to file a claim. Negative Māori experiences with the

ACC, as well as delivery of services that are not aligned with Māori values and limited knowledge of the claims process, all contribute to reduced access by Māori to full Scheme entitlements and services. This in turn leads to frustration with the current system and a desire for improvement.

- 297 There is a general view among Māori that ACC has not provided adequate information about entitlements and claim processes to them. This in turn hinders access by reducing the Scheme's perceived value within the community as well as making it less likely people will pursue the correct pathway to obtaining Scheme services. Recognition of the lesser service results in less motivation to file claims, which results in further diminished services, which lead to further perceptions of inadequate care.
- 298 Māori reported dissatisfaction with the ACC, particularly around ACC staff and processes, which are perceived as slow and cumbersome and not attuned to Māori values. Dissatisfaction is more evident when considering medium term issues such as weekly compensation. Māori interviewed in the course of this research clearly wanted the ACC to have more culturally competent staff and also voiced their dissatisfaction with the communication skills of many ACC staff and providers. It was clear that these issues continue to create barriers to Māori utilisation of the Scheme. ACC moves to include cultural factors in its ethnic research disparities programme will enhance its ability to engage with these issues.
- 299 Māori do, however, have a positive view of the ease of access to the Scheme for acute treatment of injuries, and support for those with serious injuries. Protocol-driven processes providing little scope for individual variation or interpretation by staff and case managers are associated with fewer disparities. For example, emergency departments often deliver care based on best practice guidelines and protocols. In this respect, ACC's routine and seamless processes are perceived to work well for Māori.
- 300 Because all Scheme services are not delivered separately from the rest of the healthcare system, the existing disparities within the larger system also impact on ACC outcomes. It is important, therefore, for ACC (or its successor(s)) to work to improve outcomes across the health sector as well as within its own infrastructure.
- 301 Another area where improvement is needed is in the explanation of ACC levies. Despite the availability of some public information, levies are poorly understood by Māori, with many desiring a better understanding of them. Many felt they are not given enough information about how their money is being spent and what value they are receiving from their payments. Others wanted programmes that offer reduced levies in exchange for use of good practices, and the existence of some limited programmes of this type within the current Scheme did not appear to be widely recognised or understood.
- 302 Māori providers do not feel fully utilised or respected by the ACC. Many Māori maintain high levels of interest in traditional Māori culture, including traditional Māori medicine.

Many Māori told the researchers that ACC's perceived rejection of such practices is viewed as another example of the ACC's non-Māori focus.

- 303 There is an overall sense that the ACC processes (eg, amount of required paperwork, lack of face to face communication, frequent staff turnover/case reassignment, etc) are not attuned to Māori needs. Respondents described at some length how the lack of concordance between Māori preferences and abilities (including such things as literacy levels) and ACC processes creates barriers for the Māori community.

### The importance of choice for Māori

- 304 The research commissioned by the Steering Group also considered the views of Māori on the potential to introduce competitive delivery to compulsory accident compensation services in New Zealand. Overall the research found substantial interest in competitive delivery models, albeit with important caveats.
- 305 A major driver of Māori interest in "choice" or competition is the assumption that any new system will at least facilitate, and ideally encourage, a greater role for Māori providers as well as a greater appreciation of Māori beliefs and tikanga. Māori interest in competition ('choice') is entirely contingent upon Māori organisations being significant players in offering these potential service and delivery choices. The major motivation for competition in this community is to achieve a system more in tune with Māori needs and values, along with a wish for lower costs and more efficiency.
- 306 Māori view cultural competency and, where possible, cultural concordance as being of great importance in the delivery of accident compensation services. The possibility of a new system that would be aligned with Māori tikanga, rather than being seen to, at best, shoehorn it in on the edges, is very appealing to many within the Māori community.
- 307 By contrast there is some scepticism about competition, based on concerns that a mainstream service will never be able to authentically incorporate Māori values, and that the new system will therefore serve Māori no better than the current system, and possibly quite a bit worse. Change may lead to confusion, profiteering, further decreases in access to and quality of services, disregard or exploitation of Māori interests, and increased costs. Some of those interviewed as part of the research conducted therefore indicated a preference that efforts be directed towards improving the current Scheme rather than developing a new competitive system that is unproven and undefined.
- 308 Although many Māori are eager to see Māori providers having a larger role in a new system they also realise that many Māori will still, by necessity or preference, receive their care from a mainstream provider. For this reason it is important to note that inclusion of Māori providers will not relieve mainstream providers of their obligation to offer culturally competent care, nor to document equitable outcomes.

- 309 The 'choice' process will also require transparency, with rules around which providers or organisations can participate and how choices can be offered. This is critical to ensure that consumers will be able to make an informed choice and that smaller providers are not disadvantaged. Overall, Māori see competition as a shift from provider choice (under a monopoly delivery model) to consumer choice (under a competitive delivery model) and in these terms it is generally viewed as positive.
- 310 Both proponents and opponents of competition voiced concerns that changes could, regardless of intentions, widen the cracks in the system through which Māori already fall at a disproportionately high rate. As a result Māori are understandably wary of new initiatives that might interfere with the parts of the accident compensation system that currently work well for them, such as the no-fault, universal coverage and (reasonably) automatic claim processes.
- 311 For changes to the ACC to be considered credible by Māori, appropriate consultation methodologies must be employed. In the absence of a rigorous and genuine consultation process it is unlikely that any substantive improvements can be made, and respondents' concerns about the inability of a mainstream organisation to incorporate Māori values will be proven accurate.
- 312 The change process should begin with more detailed consultation on what if any changes are in fact desired, with further consultation around the form these changes might take. Once agreed, changes to the Scheme will need to be presented via targeted communication to the community, because this has been proven most effective in sharing information, raising awareness, and minimising disparities.

## Conclusion

- 313 There are substantial disparities in Māori and non-Māori utilisation of the ACC Scheme. In particular Māori are less likely to use the ACC Scheme for minor injuries, and are heavily over-represented in serious injury claims. Improvements to the Scheme, either within the current model of monopoly delivery or through competitive private delivery, must both address access issues and serious injury prevention, and aim rehabilitation initiatives specifically at Māori.
- 314 For the disparities between Māori and non-Māori in the Scheme to be addressed, there will need to be a much stronger focus on the dissemination of information about the basis on which ACC levies are set, access to the Scheme, and the benefits provided by it. There will also need to be much more investment in the cultural competence of the frontline staff of the ACC. The ACC will also need to find ways to work with primary healthcare providers as the principal gateway to the ACC.
- 315 While Māori support retention of the current compulsory no-fault accident compensation system, many Māori are interested in and supportive of the introduction of competitive

delivery of the ACC Scheme which they characterise as a shift from provider choice (under a monopoly delivery model) to consumer choice (under a competitive delivery model). However there are some important caveats. A major driver of Māori interest in 'choice' or competition is the assumption that any new system will at least facilitate, and ideally encourage, a greater role for Māori providers as well as a greater appreciation of Māori values and tikanga. Support for competition is contingent upon Māori organisations being significant players in offering these potential choices.

- 316 The interest of Māori in choice and competitive delivery as a mechanism through which they may benefit from the advantages of specialist service providers is indicative of one of the fundamental problems that besets monopoly providers – their inability to provide adequately for specialist niches in markets. One of the key opportunities provided by the introduction of competitive delivery is the emergence of a range of niche providers of accident compensation services that will better serve not just Māori but a wide range of different groups within New Zealand society.
- 317 Many Māori are also concerned that changes to the delivery model for accident compensation may, despite the best intentions, further perpetuate a single mainstream model of delivery and result in a continuation of the disparities currently evident in the ACC Scheme. For this reason, some Māori would prefer that there be a focus on improving the ability of the ACC to meet the needs of Māori, though it is unclear to what extent this can be done under the current delivery model.
- 318 For changes to the ACC to be considered credible by Māori, appropriate consultation methodologies must be employed.
- 319 Finally, the concerns expressed by Māori respondents and the issues raised in the preceding analysis are likely to be common to other groups in society who share similar socioeconomic profiles, who are characterised by an increasingly youthful demographic base, and who reside in rural areas.

**Recommendation:** Require that the ACC develops options that would allow a much wider range of organisations to participate in the delivery of accident compensation services, particularly those that can assist in providing more cost-effective services to different ethnic and socio-economic groups within the community

## 7 Governance, regulation, and monitoring

### Introduction

- 320 The ACC is a Crown Agent – the closest of all statutory Crown entities to government.<sup>35</sup> The ACC is also a very large public monopoly provider of insurance services. The scale of the business of the ACC ranks it as the fifth largest financial institution in New Zealand; smaller than the big four banks, but larger than the New Zealand operations of any other insurance company.
- 321 Governance is important for large organisations such as the ACC because it is the mechanism by which the owner of the organisation attempts to ensure that the actions or management are consistent with the owner’s interests. In particular, effective governance will serve to ensure both (i) efficiency in the pursuit of the objectives specified by the owner, and (ii) the ability of the owner to determine the allocation of any benefits from increasing efficiency. Efficiency in the pursuit of the objectives of the owner will require that the governance structure provides management with a performance and risk-management strategy from which may be identified clear and readily monitored objectives.
- 322 Large financial institutions present substantial challenges for governance, regulation, and monitoring because of the complexity of their business, the challenges in managing the risk associated with financial instruments, and their impact on the wider economy. In particular, as events in international financial markets over the past two years have shown, the potential speed and scale of the change in the risk associated with the business of any financial institution mean that the whole Board needs to be attentive to short-term changes in the risk associated with the business. In the case of the ACC the challenges associated with governance are amplified by government ownership and the multiple objectives that normally characterise public sector entities.
- 323 For the Board to be able to manage the risks associated with the business, a number of criteria must be met. First, the objectives of the institution must be clear and consistent. In the case of private sector enterprises, maximising value for shareholders creates a clear objective for management and the Board, but for a public sector entity such as the ACC the objectives are less clear and in some cases different objectives may even be contradictory. Second, the Board must have appropriate expertise in the business, and receive sufficient and timely information to allow it to assess the performance of management and of the business overall. Third, the governance structure must be clearly defined, and provide senior management and the Board with strong incentives to pursue, and clear accountability for pursuing, the objectives of the firm. Fourth, there must be effective mechanisms for monitoring the performance of the Board and senior

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35 The others being Independent Crown Entities, Autonomous Crown Entities and State-Owned Enterprises.

management, and dissemination of information about their performance to the ultimate owners. In the case of the ACC, this means that monitoring is undertaken by government departments advising stakeholder Ministers.

324 In this section we first review the statutory framework for governance and monitoring and then examine each of the above criteria in the context of the ACC.

## Governance structure of the ACC

325 The Crown Entities Act 2004 determines ACC's accountability. The ACC is a Crown Agent; the closest to government of the statutory Crown entities. This means that ACC Board members are appointed by the Minister and may be removed at the Minister's discretion. Crown Agents must give effect to (rather than just "have regard to") government policy when directed by the responsible Minister. Crown Agents must also give effect to "whole of government directions" from the Ministers of State Services and Finance.

326 The key elements of the governance structure of the ACC are as follows:

- i ACC has a Board, appointed under the Crown Entities Act 2004 and the Accident Compensation Act 2001, which reports to the Minister for ACC. The Crown Entities Act 2004 sets out the collective duties of the Board. The Board is accountable to the Minister for the performance of the organisation as a whole. The Board currently consists of a Chair, a Deputy Chair, and six other members.
- ii The Board does not, however, have the power to set levy rates or changes to classifications of accidents and benefits. The Board makes a decision on the rates to be consulted on for individual levies, and the Minister must consult on changes to classifications. As a result of the consultation process the Board will make recommendations for levy rates and classification changes. The Minister then makes a decision on recommended regulatory changes, which are considered by Cabinet. The final decision to strike rates and on changes to classifications lies with the Minister for ACC (though in effect levy rates are determined by Cabinet).
- iii The Chief Executive is responsible for the day-to-day operational management of the ACC. There is a statutory requirement for the Board to consider the advice of the State Services Commissioner regarding the appointment of the chief executive, and in particular the conditions of employment, but the decision on the appointment of the chief executive rests with the Board.
- iv The Department of Labour receives a specific appropriation from the Government through Vote:ACC to fund ACC-related activities. It is the agent of the Minister in monitoring ACC's performance and legislative compliance. The Department of Labour also gives advice and support to the Minister relating to Board member appointments and induction, the Corporation's strategic direction, planning process, output agreements, and annual levy recommendations.
- v The Board's accountability to the Minister and Parliament is recorded annually in a suite of documents. These include the Statement of Intent, and the Service

Agreement with the Minister for ACC that also includes accountability for the Non-Earners' Account:

- a The Statement of Intent has a multi-year focus and is tabled in Parliament. It is a strategic document designed to give Parliament a full and balanced view of the ACC's objectives and outcomes, strategy, capability, and performance.
- b The Service Agreement with the Minister for ACC is the agreement between the Board Chair and the Minister on the management of the Scheme. It includes the Non-Earners' Purchase Agreement related to the management of the government-funded Non-Earners' Account.

## Clarity of objectives

- 327 Effective governance, management and monitoring require clear, consistent, and complementary objectives. In contrast, the ACC has had in the recent past multiple objectives that have often been conflicting and its performance has suffered as a result. In particular, there has been a lack of alignment between the objectives of the Crown, the internal targets of the ACC, and the assumptions on performance included in the actuarial valuation.
- 328 The ACC Statement of Intent 2009 - 2012 identified seven strategic priorities:
- ensuring New Zealanders will know and understand how ACC can help them and feel confident in approaching ACC
  - maintaining a fair and stable levy environment that enables levy payers to plan with certainty
  - people-focused with good outcomes sustaining high levels of satisfaction among all ACC stakeholders
  - open and fair access ensuring that ACC is easily accessible and available providing fair outcomes for everyone in New Zealand
  - working to reduce injuries and occupational diseases. ACC will create a safer New Zealand and will significantly reduce injuries with serious consequences.
  - ACC will be a world class organisation that is both efficient and sustainable
  - a focus on tailored, personal rehabilitation and support so that people return to productive life.
- 329 The potential for conflict between these objectives is readily apparent. In particular, the potential tension between the priorities designed to promote access to and utilisation of the Scheme (especially "providing benefits that are easily accessible and available") and the priorities aimed at efficiency and sustainability (including a stable levy environment) lie at the core of the poor financial performance, and deteriorating return to work outcomes, of the Scheme between 2005 and 2009.

330 The Steering Group notes that the ACC Statement of Intent from 2010 – 2013 provides a substantial revision and refocusing of these priorities. It provides three priorities for the ACC:

“To ensure the ACC Scheme is financially sustainable and represents value for money. ACC’s primary role is to provide effective rehabilitation for all New Zealanders who have an injury. It has an obligation to deliver good outcomes for clients, while also demonstrating value for money in its use of levy payers’ investment in the Scheme. As such, while delivering successful client outcomes is critical to the success of the Scheme, so too is ensuring that these outcomes are achieved at a reasonable cost.

To support injured New Zealanders to recover their independence to the maximum extent practicable through the provision of cost-effective, outcome-focused rehabilitation services. Rehabilitation is the key mechanism through which ACC supports clients to achieve their rehabilitation outcomes and minimise the time they are receiving support, thereby reducing the cost of the Scheme.

To reduce the incidence and severity of injury. ACC’s primary role in injury prevention is to co-ordinate the efforts of other government agencies, through leadership of the New Zealand Injury Prevention Strategy (NZIPS), and the associated Chief Executives’ Injury Prevention Forum.”

331 These three priorities are clear, directly linked to identifiable performance measures, and largely free of the potential inconsistencies apparent in the earlier priorities. In this sense, they provide a relatively strong basis for governance and management accountability. We therefore endorse the recent changes to the priorities for the ACC, and expect that this change will provide a stronger basis for the governance framework of the ACC in the future.

## Board composition and competencies

332 The complexity of the business of financial institutions, the public interest in the operation of the ACC, and the impact of the ACC on the Crown accounts all suggest that a key objective of government should be to ensure that the Board of the ACC has members with the experience, capacity, and time to provide effective oversight and governance of the organisation. The recent international financial crisis has drawn attention to the importance of non-executive directors in providing effective scrutiny of management, and the importance of ensuring that those directors commit an appropriate amount of time to understanding the business of the organisation.<sup>36</sup>

333 For most directors, the competent exercise of governance responsibilities for an organisation as complex as the ACC will require the commitment of 30-36 days per year. For the Chair of the Board, the time commitment must be at least double that amount.

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<sup>36</sup> The material in this section draws on the recent review of corporate governance in the financial sector of the UK: Sir David Walker *A review of corporate governance in UK banks and other financial industry entities*: final recommendations 26 November 2009.

The remuneration provided to the directors must be consistent both with this expectation of time commitment, and with the level of professional expertise and experience that is required for effective governance in a complex financial institution such as the ACC.

- 334 The Board must be satisfied with the quality and the capability of the Chief Executive and the senior management leadership. It needs to be as free as possible to set remuneration at a level that will attract senior executives with appropriate experience in the management of large and complex financial institutions. This will require the Board having the ability to offer remuneration outside the standard salary ranges for executives of a Crown Agent such as the ACC.
- 335 The Board must be capable of providing constructive challenge to proposals on strategy put forward by the executive. Board members should satisfy themselves that Board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information, and draws, as far as they believe it to be relevant or necessary, on external analysis and input.
- 336 The Chair of the Board should have both financial industry and leadership experience, and should be expected to commit a substantial portion of her/his time to the business of the entity. There should be a clear understanding that, should it be necessary, the role of Chair would have priority over any other business time commitment. The Chair of the Board of a major financial institution such as the ACC should be willing to spend at least 60 days per year on the role, including in meetings with the Chief Executive, in ensuring that the other directors are receiving accurate and timely information and that the business of the Board is sufficiently focused on the key issues. Remuneration consistent with this level of expertise and time commitment should be offered to attract an appropriately qualified person.
- 337 The Minister should require that the Board of the ACC has a risk committee separate from its audit committee, with responsibility for oversight and advice to the Board on the current risk exposures of the organisation and the future risk strategy. That committee would be responsible for ensuring that the executive team includes a chief risk officer independent of the chief financial officer with responsibility for assessing the risk associated with all new initiatives, programmes and benefits provided by the ACC.
- 338 The Board should undertake a formal and rigorous evaluation of its performance, with external facilitation of the process, every second or third year. The process should include both an evaluation of the performance of individual Board members, and an evaluation of whether the skills and experience of the members collectively provide the capability required to ensure effective governance of a large financial institution.
- 339 Finally, we note that in the context of the ACC one other requirement for Board composition and membership is important. Unlike directors in the private sector, the personal wealth that directors of the ACC have at stake in the performance of the

organisation is small because there is no opportunity for them to take an equity stake or equity option in it. The decisions of state sector directors are also not subject to the same intensity of scrutiny as those of private companies where capital markets are normally efficient mechanisms for disciplining poorly performing boards. This means that the normal requirements for professional experience and standing are amplified in the case of the Board of the ACC. Directors of the ACC must be persons with the highest professional standing, and who will therefore be most focused on avoiding the personal reputational damage that would result from poor performance at the ACC.

- 340 Given the importance of the quality of the people appointed to the ACC Board, the Steering Group has considered whether there are opportunities to make the process for the appointment of Board members more robust and transparent. In addition to the normal requirements for the appointment of directors of Crown entities, we recommend that appointments of ACC Board members should meet the same standards that are required by financial sector regulators of private sector financial institutions in Australia and New Zealand. While it may be possible to utilise the same regulatory oversight processes applied to board appointments in private sector financial institutions, the Steering Group considers that there is merit in the suggestion made by the 2025 Taskforce that the government considers the establishment of an independent Crown Commercial Appointments Commission, which would vet and publish suitability assessments of candidates for appointment to the boards of Crown enterprises such as the ACC.

**Recommendations:** Provide for time commitments and remuneration of Board members consistent with recognition that the ACC is the fifth largest financial institution in New Zealand. Consider mechanisms that will provide for higher levels of scrutiny of appointments to the ACC Board, consistent with the standards that would be set for large private sector financial institutions.

## Regulation: levies, benefits, and service levels

- 341 Because it is a monopoly provider of compulsory accident compensation services in New Zealand, the market mechanisms for constraining corporate power and penalising poor performance that apply to private sector providers of insurance do not impose themselves on ACC. This means that some form of regulation has the potential to improve the efficiency with which the ACC operates, though that regulation will rarely be as effective as competition in providing high levels of efficiency.
- 342 Regulation is the imposition of economic controls by government agencies on the activities of a business enterprise. Regulation normally focuses on setting the prices charged by enterprises that have monopoly power at the efficient (competitive) level, and in addition, on minimum standards for service and quality. The multiple foci of regulation are required because firms with monopoly power can earn returns above the competitive level either by setting prices too high, or by delivering lower quality services. In the case of the ACC,

shareholders are not the beneficiaries of monopoly return, as they would be from private monopolies, but monopoly “rents” may still be earned and dissipated through a variety of mechanisms such as over-staffing, higher pay rates for management, and job security that is not linked to performance.

- 343 A core component of the regulatory regime applied to the ACC is the legislated specification of benefits. This has advantages in minimising the potential for the ACC to avoid providing benefits to which claimants are entitled. But it contains two significant elements of inefficiency. First, in respect of services relating to rehabilitation it may be the quality of the services provided, rather than the services themselves, that provide the greatest scope for the ACC to use its monopoly position to reduce the value for money received by claimants. Second, efficiency would be enhanced if the ACC were able to offer variations on the nature and level of cover provided for accidents, rather than only the cover provided by statute. While addressing these elements of inefficiency in the ACC Scheme will be problematic under state monopoly provision, the Steering Group considers it likely that it would be possible to address them under a regime of competitive private delivery.
- 344 As we have pointed out above, ACC levy rates and changes to classifications are set by Order in Council following the advice of the Minister to the Cabinet. The Minister’s decision on the levies to be set is based on the recommendations provided by the ACC, a public consultation process, and advice from the Department of Labour. One way to view this process for setting levies is as a compromise between two important objectives: the provision in the Constitution Act that taxes can be levied only “by or under an Act of Parliament”, and the importance of holding the Corporation accountable for the financial performance of the Scheme. Another way to view the current levy setting process is that it represents a form of regulation, in that it constrains the power of the ACC to set levies. Our view is that whichever of these perspectives is adopted, the current levy process is markedly inferior to normal price discovery arrangements.
- 345 The public consultation process provides the government with input on community preferences, as is illustrated by the ongoing debates on motorcycle levies. We understand that some levy payers value the consultation process, particularly interest groups that expect to be able to exert enough political influence to obtain private benefits from the process. However it is doubtful that the consultation process provides information of substantive or probative value beyond the observation that levy payers prefer lower levies. In addition, there is a danger that a consultation process will lead some members of the public to presume that levy or taxation rates are set on the basis of preferences rather than financial imperatives. Ministerial discretion will normally be available only in determining how the financial burden is spread across different groups within the current cohort of levy payers (based on income or risk) or across different cohorts of levy payers (based on paying less than the full cost in the short-term), and does not relate to the total

amount of money that needs to be raised. In other words, consultation – notwithstanding its obvious benefits - has the danger of encouraging politically expedient choices based on the power and activity of different interest groups rather than on the efficient allocation of costs.

- 346 From the perspective of effective governance, Ministerial discretion on levies has a substantial impact on the accountability of the ACC Board and management for operating the ACC on a prudent financial basis. As long as the Board does not have the power to set the levies to be paid, it will be extremely difficult to monitor its performance and hold it accountable for the achievement of financial stability. Deterioration in financial performance will always have the potential to be explained by the setting of levies at rates lower than those recommended by the Board of ACC.
- 347 If financial and operational stability in the ACC are to be taken seriously as important short and long-term objectives of the ACC Scheme, and if the Minister is to be isolated from pressure to make political rather than financial decisions about the levies, then the power to set the levies must be delegated to the Board of the ACC.
- 348 Delegation of the power to set levies to the Board of the ACC will be imperative if competition is to be introduced to any Accounts and the ACC is permitted to operate as a competitive insurer alongside private sector companies. This is because:
- levy setting at a competitive insurer should be based on the most recent information about claims experience and investment returns, and as such must be completed over a relatively short time period
  - a competitive government-owned insurer would be required to meet the same requirements for solvency as private sector insurers, and thus could not tolerate the exercise of political discretion to keep levies low
  - any relaxation of the assumption above that a government-owned insurer would have identical operating and prudential requirements to its private competitors is likely to result in private insurers being unwilling to enter the competitive market.
- 349 The Steering Group considers that if public monopoly delivery of the ACC Scheme continues then government faces a choice: if the ACC Board does not have the power to set levies it will be extremely difficult to hold them accountable for the overall performance of the Scheme, but on the other hand, letting the Board set the levies potentially raises constitutional difficulties and also may increase the monopoly power of the ACC. Despite these difficulties, we consider that there is a strong case for giving the Corporation the power to set ACC levies directly after a process of consultation required (as now) by law, and subject to some *ex post* review either by Parliament's Regulations Review Committee or some other body. Providing the Board with the power to set levies has the advantage that it provides transparency, and it would make it clear that the main purpose for regulation would be to limit the monopoly power of the ACC.

350 We have considered whether the Minister for ACC should retain the power to issue a Ministerial directive to the ACC to alter the rates that it has announced, either because of general economic conditions or because of concerns about the ACC's operations. This situation would be superior to the current process for levy setting, in the sense that it would create a stronger separation between the political and operational responsibilities and greater transparency in the political choices made. However, it would also create the potential for many of the problems of the current levy-setting process to be perpetuated, including instability in the ACC Scheme and erosion of the accountability of the ACC Board and senior management for the performance of the Scheme.

351 A key element of the regulatory regime applied to private sector insurers is the requirement to meet the standards for capital adequacy and reporting set by financial sector regulators. The Steering Group has noted that the ACC will be outside the framework for the regulation and supervision of the insurance industry that is being established by the Reserve Bank of New Zealand. So long as the ACC does not have equity capital, it is difficult to see how private sector regulatory frameworks could apply to it. However, the advantages of including the ACC within the regulatory framework, in terms of the ability of the monitoring framework to use performance benchmarks from the private sector, would be material. And since ACC would need to have equity capital in respect of any Accounts that were opened to competition but in which ACC operated as a competitor, the government should consider the costs and benefits of providing equity capital and including the ACC within the framework for insurance industry regulation and supervision.

## Monitoring

352 As a publicly-owned monopoly, the ACC is not subject to the level of monitoring of its performance by investors and potential investors trading in equity markets or by customers who have options to choose an alternative provider. This means that the effectiveness and timeliness of the monitoring regime instituted by government will be critical in identifying any shortcomings in the performance of the ACC.

353 There are four primary components to the external monitoring regimes currently in place for the ACC:

- the production by the ACC of reports for senior executives and the Board, normally on a monthly basis
- the production by the ACC of quarterly reports, and commentary on those reports by the Department of Labour
- bi-annual reports prepared by the Department of Labour for Cabinet. These concentrate on explaining the results of previous actuarial valuations, and recent trends in areas such as claimant satisfaction and rehabilitation rates.

- ACC's annual report, which focuses on reporting against the targets established in the Statement of Intent.
- 354 The Steering Group commissioned independent advice on the quality and effectiveness of this monitoring regime. That advice suggests that there is scope for substantial improvement in the nature of the indicators used as the basis for monitoring, the comprehensiveness of the monitoring, and the timeliness of the monitoring.
- 355 The single most important monitoring objective associated with the ACC must be the comparison of ACC's operating experience with the assumptions contained in the most recent actuarial valuation of the Scheme. Inter-valuation claims experience that precisely tracks the forecasts embedded in the opening actuarial valuation is likely to be financially neutral for the ACC. Operating experience that is less favourable than the forecast in the valuation is likely to have a negative impact on the finances of the ACC. Therefore, surveillance against targets drawn from the actuarial valuation is essential if the monitoring framework is to provide early warning of unfavourable financial experience and the opportunity to require the Board and management to implement corrective action.
- 356 To complement the role played by external monitoring of performance against the targets set by the assumptions of the actuarial valuation, it is also important that the key performance indicators of management be tightly aligned with these assumptions. An important contributor to the poor performance of the ACC in the recent past has been the fact that the key performance indicators of the ACC management have not been focused on ensuring that the levels of performance assumed in the actuarial valuation are achieved.
- 357 The timeliness of monitoring is also critical. At present the timeframes associated with the preparation of monitoring reports, Department of Labour commentary on those reports, and the Minister's consideration of issues arising from them, is unacceptably long. The time frames for the preparation and consideration of these reports must be brought much closer to the standards that would apply to investor monitoring of the performance of private sector companies.
- 358 The Steering Group has also considered whether there is potential to improve the current institutional arrangements for monitoring the ACC. The delay in the identification and response to the recent problems with the performance of the ACC at least suggest that monitoring of ACC has not, under current institutional arrangements, received the required level of focus, given the impact of the ACC on the economy and the Crown's balance sheet. The monitoring of the ACC requires specialist skills in the interpretation of actuarial information and in business performance monitoring, and it may be difficult for these skills to be recruited by the Department of Labour.

359 A greater concentration of the required expertise exists within the Treasury, and we are aware that Treasury has plans to increase its capability in and focus on the monitoring of state sector enterprises. But a transfer of monitoring responsibility to the Treasury would require departmental separation of responsibility for ACC policy and ACC monitoring. Formal recognition of dual roles has, with current modes of operating within the public sector, the potential to increase the time required for any monitoring reports to be available to the Minister.

360 The Steering Group has therefore reached the view that improvements in monitoring do not necessarily require a change in the location of the primary monitoring unit. Rather, improvements in monitoring are more likely to result from:

- greater clarity of the objectives for the ACC
- a tighter link between measures of performance and the assumptions of the actuarial valuation
- a focus on independent analysis rather than simply on commenting on reports provided by ACC
- a culture of constructive challenge, and a search for different measures and interpretations of performance, rather than acceptance of the information and frameworks for analysis provided by the ACC.

361 We believe these improvements in monitoring have more to do with the capability and mandate of the staff assigned to undertake the monitoring than they have to do with the departmental location.

362 Despite its public monopoly franchise, some components of the monitoring regime used by the private sector may also be of assistance in monitoring the performance of the ACC. The recent requirement for the ACC to prepare an annual report on its financial condition is an important step in the right direction. Those who claim that government ownership means that the ACC should not need to follow private accounting and actuarial standards usually base that claim on the absence of default risk. In doing so they ignore the relevance of these standards to transparency in assessing management performance and governance. This is critical for management of the liability and for management and Board accountability for performance.

**Recommendations:** Require that the ACC management performance objectives are tightly linked to the key assumptions in the actuarial valuation as a means of minimising unanticipated increases in outstanding claims liabilities.

Improve the quality and timeliness of monitoring of ACC performance by ensuring that monitoring imposes a tighter link between measures of performance and the assumptions of the actuarial valuation, and is conducted with a focus on independent analysis and a culture of constructive challenge rather than acceptance of the information and frameworks for analysis provided by the ACC.

## Conclusion

- 363 Effective governance, regulation, and monitoring of the ACC are extremely difficult to achieve. This is because the ACC combines the complexity of a large financial institution and the potential for inefficiency that arises from public ownership and monopoly provision. The suggestions for improvement made in this section of our report may produce improvements in efficiency under the current framework of public monopoly delivery, but even if fully implemented they will still leave governance, regulation, and monitoring at levels that are weak by private sector standards. The performance of boards is inevitably reduced by the lack of financial incentives for directors to improve the value of the firm, regulation can at best only produce a weak approximation of the consumer benefits that come from competition, and the incentives of civil servants to produce timely and insightful monitoring is inevitably less than the incentives that apply to shareholders and customers of competitive firms who have choices about where they invest or buy services.
- 364 Any shortcomings in the governance and monitoring framework are likely to create substantial risk of poor performance. For example, a singular focus on financial performance may result in a reduction in service delivery rather than increased efficiency, since the ACC faces no short-term competitive sanctions (such as loss of market share) from less satisfied customers. Alternatively, a focus on customer satisfaction may result in poor financial performance, with deteriorating claims and rehabilitation rates regarded simply as a necessary cost of promoting access to and utilisation of the scheme. Without competition the best that can be hoped for is to design a governance, regulation and monitoring framework that approximates the discipline on financial performance and service delivery that would be provided by competitive markets.
- 365 The poor performance of the ACC over the last five years has flowed directly from the complexity of the objectives of the ACC, and in particular objectives that were inconsistent with levy stability and long-term financial sustainability. Multiple and potentially conflicting objectives are a highly effective mechanism for reducing the effectiveness and accountability of any governance structure that is in place. Such lack of clarity increases both the cost of monitoring and the discretion of management and the Board to follow their own agenda(s), while at the same time greatly reducing the accountability of management and the Board for meeting any particular performance targets.
- 366 Management performance objectives that were not tightly linked to the key assumptions in the actuarial valuation created the potential for regular deterioration in the performance of the ACC. The new objectives adopted by the ACC Board in the Statement of Intent for 2010-2013 provide a basis for improved performance so long as greater accountability for meeting those objectives is placed on executive management and the Board.

- 367 Members of the ACC Board must be persons with the highest professional standing, and who will therefore be most focused on avoiding the personal reputational damage that would result from poor performance at the ACC. The government should therefore consider requiring that Board members meet the same standards that would be expected of directors in private sector financial institutions, and establish a mechanism for independent scrutiny of proposed members consistent with this standard. Accountability will also be enhanced if senior executive positions at the Corporation are remunerated consistent with the expertise appropriate to lead and manage the largest insurance business in New Zealand, and if Board member remuneration is consistent with the expertise and the time commitment required for such a large and complex business.
- 368 The monitoring of the ACC by government departments has been neither effective nor timely in identifying performance problems of the ACC. This appears to reflect the confusion of objectives and accountabilities that has characterised the ACC in the past, and the lack of a clear performance monitoring framework linked to the assumptions in the actuarial valuation. However it also reflects the fact that most government departments are not well equipped to provide the complex commercial analysis and monitoring required for the ACC. The requirement introduced in 2010 for the Corporation to prepare an annual report on its financial condition is likely to improve the quality of the monitoring of the ACC and will provide a benchmark on which greater accountability for financial performance can be based. Despite these changes it is likely that process and capability issues will remain.
- 369 Finally, the governance and monitoring problems at the ACC can be reduced by an operating framework that requires the Board and management to ensure that the required services are delivered at costs consistent with the funding available. This level of accountability will not be achievable so long as the power to set the levies for the ACC Accounts rests with the Minister rather than the Board because it removes from senior management and the Board the core accountability for the short-term financial performance of the Corporation. To address this issue, and if the most obvious remedy provided by the introduction of competition is not adopted, the Steering Group recommends that consideration be given to reconstituting the ACC as a State-Owned Enterprise with explicit equity capital. Constituted in this way, monitoring problems could be reduced to some extent by subjecting it to the regulatory and prudential supervision requirements of, and direct comparison with, private sector insurers.

**Recommendation:** Reconstitute the ACC as a State-Owned Enterprise with explicit equity capital and, to improve its accountability for the performance of the ACC, provide for the ACC Board to set levies subject to regulatory oversight.

## 8 Improving financial performance, value for money, and efficiency in the ACC Scheme

### Introduction

- 370 The analysis in the previous sections of this report has demonstrated that the financial performance of the ACC Scheme has deteriorated over the past five years, resulting in:
- a sharp increase in the size of the Scheme's unfunded liability, with this liability appearing on the balance sheet of the Crown
  - increases in the levies required to fully fund the higher level of expected costs of providing benefits
  - an extension of the period over which levies to cover the past unfunded liability will need to be paid for the ACC Scheme to reach full funding.
- 371 These symptoms of the deterioration in Scheme performance have raised awareness on the part of a very broad group of stakeholders that includes government, firms, and members of the public who pay levies as employers, earners, motor vehicle owners, and general taxpayers contributing to the Non-Earners' Account that the long-term sustainability of the ACC Scheme requires that we identify opportunities for the Scheme to deliver improved value for money.
- 372 Options to improve financial performance and value for money necessarily require consideration of efficiency. This is because it would be inappropriate for reductions in Scheme costs to be achieved by measures that also reduce efficiency (for example by cutting programmes that have net benefits for society). Similarly, the ability to retain programmes offered by the ACC is enhanced if their efficiency can be improved.
- 373 Consideration of efficiency focuses attention on the use of resources, including their allocation to different activities or outcomes, the quality of the design of the insurance cover and the services provided, and the costs that the ACC incurs in offering those products and services. Consideration of efficiency also focuses attention on the incentives provided by the Scheme for decision-making by firms and individuals in society, in particular the incentives to avoid accidents, minimise Scheme costs, and optimise return to work.
- 374 This section begins with an examination of the efficiency of the products offered by the ACC, and in particular an examination of the extent to which there are inefficient cross-subsidies in the current structure of coverage and levies that could be removed to provide better value for money to levy payers. We then look at broader aspects of the Scheme that provide opportunities to improve financial performance and efficiency, including the importance of managing entry to the Scheme, long-term claims, and the structure of the co-insurance or co-payment provisions within the Scheme.

## Risk rating and experience rating

- 375 As we have outlined in section 3, insurance involves the pooling of similar classes of risk so that for the payment of a premium (or levy in the case of a compulsory scheme such as the ACC) each individual bears in any given year only their share of the costs arising from accident experience of the pool as a whole. The definition of the boundary characteristics of each risk pool balances the need to ensure relative homogeneity in the risks included in that pool, and the transaction costs of identifying and setting different premiums or levies for different classes of risk. The homogeneity of the risks in each pool is important because an individual who is identifiably lower risk than the average in their pool, but who pays the same premium or levy, will provide other members of the pool with a cross-subsidy.
- 376 Some cross-subsidisation is inevitable in any insurance scheme because the transaction costs of identifying different classes of risk and setting appropriate premiums or levies can be high. However, efficiency requires that the amount of cross-subsidisation is minimised because cross-subsidisation implies that the price signals being given to some individuals are incorrect, and may not provide them with appropriate incentives to avoid the contingency insured against. For example, cross-subsidisation will mean that some individuals will believe their risky behaviour is less costly to the insurance scheme and to society than it actually is. Conversely, low-risk individuals may not be adequately rewarded for behaviour that imposes much lower costs on the insurance scheme.
- 377 Cross-subsidisation can be reduced by risk rating and by experience rating. Risk rating involves the adjustment of premiums or levies *ex ante* on the basis of the observable characteristics of the insured party. Experience rating is a modification to levy-setting where the costs of the levy are determined by insured's own experience. Most insurers use both risk rating and experience rating. Risk and experience rating allow individual levy payers to achieve adjustments to their levy reflecting their own risks and management of those risks. Risk and experience rating also recognise different levels of risk between levy payers within a classification.
- 378 A common example of risk rating is the setting of higher premiums for people engaged in activities that carry a high risk of injury. When risk rating is not used, or used only to a minimal extent as at present in the ACC, employers in industries with high injury rates are being subsidised by employers operating in lower risk industries. Whatever the base levy or premium, an employer with a better-than-average safety record could be offered a lower premium as a reward for that record. Experience rating provides for the setting of levies based on the actual claims experience of the insured party. Where experience rating is used, the premium could be subject to adjustment *ex post* on the basis of the accident record of the firm during the relevant period and would normally be structured to provide a refund of the premium for injury rates lower than forecast.

- 379 Within the ACC Scheme, and until the re-introduction in 2010 of the power for the Scheme to use experience rating, self-insurance by employers operated as an all-or-nothing choice with the limited premium differentials of the Scheme risk pools being the only alternative to self-insurance. We discuss the current ACC self-insurance regime in more detail below. However in competitive insurance markets, much more complex arrangements exist to encourage firms to make greater investments in safety and accident prevention, as well as facilitating early return to work.
- 380 In Australia experience rating is widely used in all workers' compensation schemes, but is a focus for competition between insurers operating within the private schemes. Under this model of experience rating, the larger is the employer (and thus the more stable is their claims experience from year to year) the more their actual costs of insurance will be related to their claims experience in each year. For the largest employers, private Australian insurers offer 'burning cost' policies in which the past claims experience of the employer is used to establish a maximum and minimum premium that the employer has to pay. Within that range the actual premium paid by the employer depends almost entirely on the employer's claims experience for that year.
- 381 This type of experience rating is socially desirable in that it has the effect of focusing the attention of employers on improving safety and reducing accidents. It provides employers with relatively strong incentives because privately underwritten markets respond very quickly to changes in claims experience by adjusting the premium range set. And by comparison with the situation in New Zealand at present, it presents employers with a wider range of choices involving partial self-insurance and tight links between claims experience and premiums paid.
- 382 The Woodhouse Report opposed risk and experience rating of levies, because it claimed:
- there is no evidence that employers can control the incidence of accidents, and the financial incentive associated with their levies is too small to induce employer investment in a safer workplace
  - experience rating may lead to the under-reporting accidents rather than a reduction in the frequency with which accidents occur
  - experience rating cuts across the notion of community responsibility to pool the costs of all accidents given the inter-dependence of different sectors of the economy.<sup>37</sup>
- 383 In the context of 21st century experience these claims have little credibility. There is substantial evidence that employer investment in workplace safety can reduce the frequency and severity of accidents, and the levies now paid by employers (as opposed to those envisaged by Woodhouse) provide ample incentives for employers to make these

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37 See Woodhouse Report paragraphs 328-336, pp.134-135.

investments. Under-reporting of accidents is inhibited by the use of health practitioners as gatekeepers for entry to the ACC Scheme, because this severely limits the potential for employer suppression of accident claims. And cross-subsidisation of businesses with a high risk of accidents is inappropriate because those businesses should face the true cost of their operations, and thereby also see the magnitude of the financial benefits to be obtained from investing in workplace safety.

384 The potential introduction of risk and experience rating represents a threat to inefficient cross-subsidies within the ACC Scheme, but it does not represent any threat to the social purposes of the Scheme. In particular, risk and experience rating, including self-insurance, are consistent with both the absence of tort liability and compulsory cover for all members of society. Risk and experience rating affect the incidence of costs (between the Scheme and employers or other groups of levy payers) but have no impact on the rights of those who are injured to obtain treatment, income replacement, and social and vocational rehabilitation.

385 In our view, experience rating should be introduced to the ACC Accounts wherever practical in order to reduce the amount of cross-subsidisation that currently occurs. This move would improve injury prevention and the financial health of the Scheme, as high-risk groups would be sent signals through the price of levies to engage in less risky behaviour. Community responsibility would be maintained even in the face of some experience rating, as the suggestions we make are for limited forms of experience rating that seek to expand on already existing forms of experience rating in the ACC Accounts (eg, differential levies for motorcycle riders). In general we expect levies to decrease for individuals who evidence a lower than average risk, and levies to increase for those individuals who evidence a higher than average risk of injury. We do not expect the degree of decreases or increases in levies to be very large, given the limited form of experience rating proposed. The details of the application of experience rating appear below.

386 The information collected by the Steering Group on international practice in the delivery of compulsory accident compensation insurance (Appendix 1) demonstrates that across the full range of schemes from public monopoly to lightly-regulated competitive private delivery regimes, efficiency is promoted by regulations that facilitate substantial use of experience rating up to and including full self-insurance for large firms.

### Self-insurance as a form of competition

387 The Accident Compensation Act provides for employers to self-insure under what is known as the ACC Partnership Programme. Employers entering this programme are subjected to an accreditation process, and are therefore known as Accredited Employers. The Partnership Programme provides two types of self-insurance options.

388 Under the first option, Partnership Discount Plans, employers manage and meet the costs of claims in either the year in which the claim occurs and the subsequent year, or the year

in which the claim occurs plus two subsequent years. Employers opting for Discount Plans receive a reduction in their ACC levies equivalent to the average claims cost for their industry group over the duration for which they have responsibility for claims management.

- 389 Under the second option, Full Self Cover, employers assume financial responsibility for claims over their full duration but they are required to hand the claim back to ACC at the end of a specified period (maximum 48 months) at the actuarially fair price for each claim handed back. Employers opting for full self cover pay ACC levies only at a level required to cover administration and some unallocated costs (approximately 10% of the normal levy).
- 390 Under Full Self Cover employers must, and Partnership Programme employers may, purchase stop-loss cover in the range from 160% to 250% of expected total claims cost.
- 391 The Partnership Programme allows employers to choose between ACC underwriting and claims management and employer self-insurance together with either employer or third party administrator management of claims. The Partnership Programme has the effect of putting employers at the centre of injury management. It achieves this by allowing employers to self-insure subject to certain mandatory stop-loss provisions. This has the advantage of creating stronger incentives for employers to:
- prevent injuries
  - manage rehabilitation costs
  - achieve earlier return to work
  - institute the most efficient claims management and administration procedures.
- 392 The Partnership Programme also ensures that there are no barriers to employer involvement in rehabilitation and return to work outcomes, and introduces competition in claims management (since accredited employers may self-manage or use third party administrators including the third party administrator owned by the ACC).
- 393 Despite the limitations on the extent and form of the self-insurance currently allowable, adoption of self-insurance by large employers has been substantial with the result that 21% of the Work Account (based on wage and salary costs) is in the Partnership Programme. In allowing employers to opt out of the services provided by the ACC Scheme when they consider that they and their employees may benefit from doing so, the Partnership Programme demonstrates benefits from the introduction of even limited competition in the delivery of accident compensation.
- 394 The Steering Group commissioned an independent analysis of experience within the Partnership Programme, and in particular, the accident and rehabilitation outcomes of employers accredited under the partnership programme compared with non-accredited employers. Employers interviewed as part of this analysis identified a number of key advantages of participation in the Partnership Programme, including:

- a decision to participate in the Partnership Programme was normally associated with an active decision taken at chief executive officer or Board level to develop a culture of accident prevention and safety in the firm and to integrate it into management accountabilities, whereas the payment of compulsory ACC levies may encourage a more passive approach to workplace safety
- management of claims by the employer (whether or not contracted to a third party administrator of claims) provides better feedback on the causes of injuries than is provided by the ACC
- the opportunity to be directly involved in a programme of rehabilitation and return to work for the injured employee results in improved outcomes for the employee and the employer.

395 In addition, employers in the Partnership Programme indicated that their primary motivation for participation is their confidence that their safety management systems provide appropriate management of the risk they assume by self-insuring, and their belief that they can implement a system for managing injury claims that is better than that provided by the ACC.

396 The current Partnership Programme has restrictions on the extent of the self-insurance exposure that individual employers can choose to adopt, as well as mandatory requirements to hand long-duration claims back to ACC. It also limits partnership to individual employers rather than groups of employers. The willingness of employers to enter the Partnership Programme is also limited by the costs of implementing claims management systems, and the audit and compliance costs imposed by the ACC. In particular, these costs limit the uptake and benefits of the Partnership Programme by medium-sized employers even though many would benefit from participation in it. Firms who are not part of the Partnership Programme have limited opportunities to be directly involved with the ACC in rehabilitation and return to work for their employees, despite the strong evidence that employer involvement leads to improved outcomes.

397 Competitive private delivery of accident compensation in New Zealand is likely to provide a basis on which the benefits of the Partnership Programme would become much more widely available. Private insurers would be likely to offer employers a much wider range of options for risk-sharing and self insurance than the ACC currently does. Given the benefits that self-insurance provides for cost-reduction and improved rehabilitation and return to work outcomes, private insurers would also be likely to be more innovative in finding ways to extend the benefits of employer self-insurance to a larger range of employers. A competitive framework for the offer of accident compensation insurance would also be likely to lead to greater outsourcing of claims management, fostering the growth of larger third party administrators with incentives to invest in the development of more efficient and effective approaches to injury management and return to work.

398 The Steering Group therefore considers that the positive outcomes of the Partnership Programme demonstrate the benefits of competitive delivery of underwriting and claims management. The Partnership Programme is an example of a programme that enhances efficiency in insurance markets, and that the ACC has adopted from the private insurance sector. However, its implementation by ACC is flawed, in part because the Corporation faces no competitive pressure to ensure that the programme works at the optimal level to provide employers with incentives to invest in safer workplaces.

399 The benefits obtained from the ACC Partnership Programme are limited by the constraints that the Corporation places on participation in the programme and the impact of those constraints on the incentives of medium-sized employers to enter the programme. Any introduction of competitive private delivery of accident compensation should provide a framework that minimises the regulatory constraints on the ways in which self-insurance can be utilised by individual employers and by groups of employers. Further, if the introduction of competitive private delivery is extended to the Earners' and Motor Vehicle Accounts, then it is our view that self-insurance against the cost of accidents should also be feasible for high net-worth and self-employed individuals, subject only to requirements for the purchase of a minimum level of stop-loss insurance.

**Recommendation:** Require the ACC to extend and improve the effectiveness of the Partnership Programme for accredited employers as a means of providing employers with incentives to invest in safer workplaces

## Applying experience rating to the existing ACC Accounts

400 Each of the ACC Accounts has a different basis for the collection of levies, so each presents different challenges and opportunities for the introduction of higher levels of risk and experience rating.

### Non-Earners' Account

401 The Crown is the sole levy payer for the Non-Earners' Account. There is therefore no direct link between those who pay for the Account and the beneficiaries of this Account. Currently no risk or experience rating is applied in this Account.

402 Reducing cross-subsidisation in the Non-Earners' Account is difficult because there is no common ground between the levy payer and the beneficiary. This is because one of the purposes of the Non-Earners' Account is to provide benefits to injured persons who may not otherwise be able to afford levies. Requiring a contribution from those covered by the Non-Earners' Account – pensioners, the young, and the unemployed – would arguably disrupt the purpose of the Account. At the same time, it is clear that there are identifiable groups within this Account who have much higher accident rates than other groups, and some of those groups do have the capacity to contribute to the cost of the cover that they receive.

403 The Steering Group recommends that all potential avenues for the rating of levies, and the collection of levies from other sources, are explored. These options include:

- having higher co-payments based on age to address the very high costs imposed on the Scheme by injuries arising from accidents involving those aged over 65 years
- placing a specific levy on tourists, or exempting them from the Scheme and requiring them to have private travel insurance to cover all contingencies while they are in New Zealand. Unlike some other categories of non-earners, tourists do not lack the capacity to pay for the accident insurance that they receive from ACC while they are in New Zealand.
- placing a specific levy on adventure tourism companies to cover the cost of accidents arising from their activities (this would also capture some of the costs imposed on the Earners' Account).

### **Earners' Account**

404 The Earners' Account is funded from levies on employees, to cover injuries sustained by employees outside the workplace. At the moment all New Zealand employees pay 2% of their salary as a levy to fund this Account. Because all employees pay the same levy rate with no differentiation based on risk or income, there is heavy cross-subsidisation in this Account. Although the concept of levying all New Zealanders equally for the costs of their non-work accidents might appeal to some as a matter of equity, the reality is that some individuals present a higher risk of injury outside work than others. Fairness to those who choose not to take risks suggests that the application of experience rating in this Account has merit.

405 There are various options for experience rating in the Earners' Account. These options include:

- higher co-payments for injuries sustained in particular circumstances (such as adventure recreation or sport), either through lower coverage or longer stand down periods
- variations in levies according to age and gender
- a requirement for individual assessment based on self-reporting of activities with high risk of injury, with higher levies for those reporting participation in high-risk activities and higher co-payments for those who are injured when they did not self-report on participation
- adventure and sports club levies (which would to some extent avoid the need for *ex ante* identification of risk through self-reporting).

### **Work Account**

406 The Work Account is funded by levies on employers and covers injuries sustained in the workplace. Currently there is some risk rating in this Account: 540 industry classification units are grouped into 117 industry risk groups or price pools. The Workplace Safety Discount, Workplace Safety Management Practices, and Workplace Safety Evaluation

schemes provide a 10% to 20% levy discount based on an audit of the firm's health and safety systems. The Accredited Employers Programme allows for both self-insurance and risk sharing; it has self-insurance options covering costs for a set time (1-3 years) or full self cover where employers pay the full cost of claims (though with compulsory re-insurance through ACC) and risk sharing options covering costs for a set time (1-2 years following expiry of cover period).

- 407 Self employed people have the option of buying CoverPlus Xtra, which allows them to agree their weekly compensation and levy at a chosen level rather than at the standard level based on their previous year's earnings. An extension to this product is under consultation now, which would give alternative stand down periods with a corresponding levy reduction (from 1 week to 90 days).
- 408 The Steering Group understands that as a result of changes to the Accident Compensation Act made in 2010, the ACC is in the process of generating experience rating for large New Zealand employers. We consider that this will result in more fairness for levy payers in the Work Account as well as stronger incentives to reduce accidents. It will be very important, however, to ensure this risk rating fully reflects the level of differentiation across different risk classes that would be adopted by private insurance markets.
- 409 The Steering Group believes there are further options for risk rating in the Work Account that should be investigated, which include:
- no claims bonuses for small employers
  - expanding the Accredited Employers Programme to more employers, perhaps by liberalising the regime for reinsurance and allowing employers in the programme to purchase reinsurance from private companies rather than ACC
  - increasing stand down periods available to all employers
  - introducing an excess for medical costs.
- 410 We also consider that there is scope to expand the Accredited Employers Programme in a way that would involve private insurers and drive efficiencies within the Work Account. Current rules requiring Accredited Employers to purchase reinsurance through ACC are inefficient, and allowing for privately-provided reinsurance would encourage more employers to participate and make the programme more efficient.

### **Motor Vehicle Account**

- 411 The Motor Vehicle Account covers all injuries sustained from crashes on New Zealand public roads and is funded from a levy on petrol and a levy on licence fees. Existing risk rating measures include differentiation of premiums by class of vehicle and a proxy for exposure to use through the collection of a levy on petrol sales.
- 412 The Steering Group considers that there are further options for experience rating in the Motor Vehicle Account that could be investigated, which include:

- applying the levy to Road User Charges (for non-petrol users)
- levying drivers by risk class (eg, age, gender, driving record, geographical location, and with a link to third party insurance)
- using income from traffic fines to supplement levies (in effect making risky drivers pay more in levies)
- imposing a tourist levy (as described above) a portion of which would go to the Motor Vehicle Account).

413 The Steering Group considers, in particular, that creating separate levies according to the risk presented by the driver, rather than assessing levies according to the risk presented by the vehicle, is an attractive option.

### **Treatment Injury Account**

414 The Treatment Injury Account covers all unexpected injuries that occur during the course of medical treatment in New Zealand. It is funded from both the Earners' Account and the Non-Earners' Account.

415 There is currently no risk rating or experience rating in this Account. This is because the individuals who are at risk of causing injury (ie, health practitioners) do not directly pay the levies that fund the Account although they are indirect levy payers for the Account as earners and taxpayers. Therefore, the application of experience rating in this Account would require re-thinking of the fundamental assumptions behind who should fund the Account.

416 Options for introducing experience rating to the Treatment Injury Account that could be investigated include:

- using the mechanism provided in the Accident Compensation Act that permits a levy to be imposed on treatment providers or their employers. If this levy were imposed, ACC could levy by class of health practitioner according to risk, or by individual health practitioner experience rating, or by organisation (eg, a district health board).
- imposing a special levy at the border for medical tourists (who already have to declare their status).

417 Levying health and medical treatment providers may be rejected by some parties as introducing "fault" back into a no-fault scheme. This claim seems inappropriate since, just as employers avoid negligence claims from their workers by paying Work Account levies, so health and medical practitioners or their employers could pay Treatment Injury Account levies to avoid negligence claims from patients injured in treatment. As a result, the Steering Group considers that although these changes would likely prove to be controversial they have merit and should be investigated further.

418 Beyond the application of experience rating to the Accounts separately, there is one potential levy that we consider could be used to fund all Accounts: namely, a levy on

alcohol sales. The advantage of this levy would be that consumption of alcohol is a likely risk factor in accidents across most Accounts, and the levy collected on alcohol sales could be set at a level that reflects the influence of alcohol on accidents in New Zealand generally. The Steering Group considers this kind of ACC-wide levy should be investigated.

**Recommendation:** Reduce the high levels of cross-subsidisation between different groups of levy payers by introducing risk and experience rating consistent with the practices of the private insurance industry.

## The limitation of competition in hybrid schemes

419 A number of workers' compensation schemes in Australia with public monopoly underwriting use competitive third party administrators for claims management. However, the Australian experience with third party administrators in monopoly schemes has been disappointing for the following reasons:

- the third party administrators work for the public monopoly underwriter rather than for the employer, so they lack the direct accountability to the employer for advice on workplace safety and improving rehabilitation and return-to-work experience. In addition, the share of the market gained by third party administrators is normally obtained through tender or negotiation with the public monopoly underwriter rather than in competition for the business of employers.
- the public monopoly underwriters have generally prescribed processes very tightly, leaving little scope for the third party administrators to develop innovative approaches to case management
- within this structure the scope for competition between the third party administrators is actually very small.

420 On the basis of the evidence available to us, we do not consider that the Australian model of monopoly public underwriting and third party administrators should be considered as a means of introducing greater efficiency or value for money into the delivery of accident compensation in New Zealand.

## The structure of co-insurance and the cost of small claims

421 Insurance companies rarely provide insurance cover without co-insurance provisions. This is because the risk of moral hazard (opportunism on the part of the insured party) increases as the share of the cost of any claim that must be paid by the insured party decreases. But one of the key features of the ACC Scheme is that the co-insurance component of benefits is relatively small, with only the weekly compensation benefit having a significant co-insurance component. The ACC funds other costs of claims, from the first visit to a health practitioner, at a higher rate than is funded by the public health system. The significance of this structure of payments is demonstrated by the recent concerns about the utilisation of physiotherapy services, when direct access for claimants

to these services was provided on the condition that the physiotherapist was not to charge co-payments.

- 422 Recognition of the importance of co-insurance in the financial performance and efficiency of the scheme formed an important part of the recommendations of the Woodhouse Report implicitly endorsed the practice of private insurers: “New Zealanders are not so dependent that they must have maximum outside assistance for every minor setback”<sup>38</sup> and that:

The real drain upon any compensation fund results from the very many payments for short-term and quite minor injuries. Accordingly it is extremely important that the level of compensation for these injuries should not be allowed to rise to a point where the majority with lesser troubles are satisfied at the expense of those whose problems are great.<sup>39</sup>

- 423 The Woodhouse Report recommended a lower level of cover for minor or short-term incapacities, noting that “The emphasis is upon incapacities which take a man away from his work for longer than three or four weeks; or which leave him with some material permanent disability”. It has perhaps been forgotten that the Woodhouse Report recommended a limit on weekly compensation of \$25 per week for the first four weeks, increasing to \$120 per week from the 5th week, with compensation for the first four weeks reassessed at the full rate if incapacity extends beyond 8 weeks.<sup>40</sup>
- 424 The absence of a requirement for co-insurance on small claims as part of the ACC Scheme is unusual because it creates a very high volume of claims for the ACC to process, with consequent implications for administration costs. In addition, even relatively low co-insurance levels have the effect of discouraging frivolous claims, and in the case of the ACC, reducing the benefit to the claimant of having a visit to a medical practitioner regarded as arising from an accident rather than any other cause. Thus, the impact of co-insurance is that it has the potential to change behaviour, and the way in which potential claimants think about the Scheme, in addition to reducing the volume of claims and the costs of administration. This suggests that the current structure of the co-insurance provisions in the ACC may be inefficient. In principle there is no reason why every claim to the ACC should not require some element of co-payment by the claimant.
- 425 The Steering Group considers that the introduction of a minimum co-payment is worthy of more detailed examination, both as a reasonable approach to sharing the burden of the ACC, and as a means of removing the current incentives to report that injuries result from accidents. Investigation of the merits of a comprehensive co-payment would also need to

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38 Woodhouse Report p.23 para 11

39 Ibid p.120 para 301

40 Extensive discussion on the issue of small claims, and the focus of compensation on long-term claims is contained in the Woodhouse Report pp.93-120.

include consideration of whether there would be a need to create mechanisms to reimburse those on very low incomes for the co-payment, and the costs of doing so.

**Recommendation:** Investigate the merits of extending the co-payment requirement associated with weekly compensation to all ACC benefits.

## Reducing the cost of claims by addressing the ‘entitlement culture’

426 To improve the value for money provided by the ACC Scheme it will be important that a range of reforms is introduced to address what might be termed the ‘entitlement culture’; that is, the perception that injured New Zealanders are entitled to income support and other benefits whenever and for as long as they wish to claim them. The alternative, and the approach that we recommend, is to return to a tighter focus on the real purposes of the accident compensation scheme – to support rehabilitation and to compensate losses associated with genuine impairment and disability resulting from an accident.

427 The areas where the greatest opportunities for enhanced value optimisation lie are:

- reducing claim duration through improving claims management service performance
- tightening the gateway by reducing the levels and costs of treatment and services provided, including rationalising the range of services available
- reducing the severity of injuries, improving the return on investment in injury prevention, and clarifying the role of others in the provision of injury prevention activities
- better managing the boundary between injury and non-injury
- improving the way health and rehabilitation service providers contribute to reducing claims numbers and duration through the better use of available incentives.

428 To achieve these improvements there is an urgent need to strike a better balance between liability management and a focus on facilitating access to ACC benefits. For much of the past decade the emphasis has been on improving access to the ACC Scheme and on customer service. This ethos shaped Corporation decision-making, internal management priorities, and goals. Capabilities associated with value for money management have been downplayed until recently. Most notably, societal expectations leading to an entitlement culture have pervaded thinking about the role and responsibilities of the ACC. The Corporation has itself reinforced this entitlement culture by not holding providers to account for delivering outcomes, nor setting clear up-front expectations with claimants and/or employers about their responsibilities in the rehabilitation and return to work process. Specifically:

- increasing the understanding of providers of the costs and liabilities they impose on the Scheme as a result of time off work certification practices, their choice of treatment options, etc

- improving the response of employers to early and partial return to work opportunities, especially for non-work related injuries
- improving self-management and enhancing personal responsibility of injured parties.

429 There are challenges in achieving these changes, as the attitudes of Corporation staff and of members of the public who see the ACC as a free ride to the consumption of health, social, and income support services are deeply entrenched parts of the culture of public monopoly delivery. The required change will therefore be most likely achieved as part of a much broader range of changes addressing the way in which the Scheme is structured.

430 To improve value for money and reduce the risk that the ACC Scheme will become financially unsustainable, there are three key areas that require more effective management: entry to the Scheme, levels of treatment, and prevention of injury. Over the past decade the ACC has not always actively managed these gateways, or considered efficiency and value for money in its approach to managing them. To address the scale of the issues facing the organisation there is a need for the ACC to adopt more business/insurance-like behaviours and competencies. This may mean changes in staffing and skills mix, the introduction of a much stronger focus on staff performance management aligned with meeting or beating organisation performance targets rather than increasing claimant satisfaction, and a consideration of whether others are better placed to provide the services.

431 Improvement in service provision, especially the management of long-term claims, will have the greatest impact on value for money. This will arise if the ACC is required to focus its efforts much more strongly on improving return to work rates, and in particular, on raising return to work rates in the first three months following the accident. As we indicated in our review of the performance data in section 5, we believe that ACC can be held to account for achieving rehabilitation rates consistent with its best historical performance, and this alone would produce substantial benefits for the financial performance of the Scheme.

**Recommendation:** Implement all practical measures to reduce the ‘entitlement culture’ currently associated with ACC and return to a focus on rehabilitation and compensation of actual losses resulting from accidents by raising public awareness that the ACC Scheme is primarily a compulsory insurance scheme with social purposes and not a social insurance scheme.

## Conclusion

- 432 The current structure of levies for the ACC Scheme incorporates inefficiently high levels of cross-subsidisation that are affecting the financial performance and value for money provided by the Scheme. Some cross-subsidisation is inevitable in any insurance scheme because the transactions costs of identifying different classes of risk and setting appropriate premiums or levies can be high. However, efficiency requires that the amount of cross-subsidisation is minimised.
- 433 Addressing this problem will require that the practices that are widely used in the insurance industry to increase efficiency and value for money are adopted within the ACC Scheme. In particular, the Steering Group recommends much wider adoption of risk and experience rating across all ACC Accounts.
- 434 Risk and experience rating are socially desirable in that they have the effect of focusing the attention of the insured parties on improving safety and reducing accidents. There is a wide range of options to introduce risk and experience rating beyond the minimal levels that currently apply to the Scheme. Other options will no doubt become apparent as a result of subsequent, more detailed work that explores, from an insurance perspective, the different ACC Accounts.
- 435 The Partnership Programme is an example of a programme that enhances efficiency in insurance markets and that ACC has adopted from the private insurance sector. However, its implementation by the ACC is flawed, in part because the Corporation faces no competitive pressure to ensure that the Programme works at the optimal level to provide employers with incentives to invest in safer workplaces.
- 436 On the basis of the evidence available to us, we do not consider that the Australian model of monopoly public underwriting and third party administrators should be considered as a means of introducing greater efficiency or value for money into the delivery of accident compensation in New Zealand.
- 437 The Steering Group considers that the introduction of a minimum co-payment is worthy of more detailed examination, both as a reasonable approach to sharing the burden of the ACC and as a means of removing the current incentives to report that injuries result from accidents. Investigation of the merits of a comprehensive co-payment would also need to include consideration of whether there would be a need to create mechanisms to reimburse those on very low incomes for the co-payment, and the costs of doing so.
- 438 Improvement in service provision, especially the management of long-term claims, will have the greatest impact on value for money from the ACC. This will arise if the Corporation is required to focus its efforts much more strongly on improving return to work rates, and in particular, on raising return to work rates in the first three months following the accident. This should be seen as part of the full range of changes that we

have recommended, all of which will assist in reducing the 'entitlement culture' currently associated with the Scheme and with returning to a focus on rehabilitation and compensation of actual losses resulting from accidents.

## 9 Conclusion to Part A

439 The Woodhouse Report was a landmark document, and key elements of the recommendations of that report have stood the test of time, in particular, compulsory provision and no-fault. But the Woodhouse Report contained fundamental flaws in respect of the implementation of those ideas. If allowed to persist these flaws will ensure that the Scheme continues to be dogged by large swings in performance and apparent affordability. The problems with the Woodhouse Report include:

- inadequate consideration of the costs of segmenting accident insurance from other parts of the insurance market
- inadequate consideration of the difficulty of defining the boundaries between the health and social welfare systems
- failure to consider the costs of monopoly and the opportunities that competition provides for the stability, effectiveness, and efficiency of the Scheme
- failure to consider the costs of not utilising the expertise of the private sector so as to allow private mechanisms to support the social purposes of the Scheme.

440 The Scheme that was created to implement the Woodhouse vision is in some senses the worst of all possible worlds; it is too generous and too easily accessed to be a social welfare scheme, and too inefficient (it lacks incentives to avoid accidents and return to work, and premiums that adequately reflect the risk that the insured party imposes on the scheme) to be an insurance Scheme.

441 The debate about whether the ACC is most usefully viewed as an insurance or a social welfare scheme is important because:

- to deny that there are social purposes in the creation of a compulsory no-fault compensation scheme is inappropriate
- to deny that the ACC is also an insurance scheme is equally inappropriate. This is particularly because prohibitions on the use of mechanisms that improve the efficiency with which insurance can be provided risks creating challenges to the financial viability of the Scheme that may ultimately undermine our ability to support its social purposes.

442 On the basis of the analysis set out in Section 3 the Steering Group has reached the view that the accident compensation provided under the ACC Work, Earners', and Motor Vehicle Accounts is properly regarded as insurance because:

- the insured parties can be identified, and a premium paid on behalf of that party
- specific contingencies are insured against, and a specific schedule of benefits is payable in the event of the occurrence of those contingencies
- the contingencies covered are more predictable in a large sample of the population as a whole than they are for any individual

- the frequency and value of claims on the accident compensation scheme are affected by the incentives established by the form and value of the compensation benefits provided.
- 443 The delivery of a very wide range of compulsory insurance against accidents by a public monopoly insurer that is not permitted to write other types of insurance and makes very limited use of the approaches to the delivery of insurance that are fundamental to the efficiency of private sector insurers is unlikely to be the best way to ensure that we can afford to maintain the social purposes of the ACC scheme. The approach taken to the implementation of the Woodhouse Report has introduced a range of inefficiencies into the New Zealand insurance market, in particular requirements for those who want to top up their insurance to over-insure and higher transaction costs resulting from the statutory separation of accident insurance.
- 444 Our analysis of the components of the increase in the outstanding claims liability between 2004 and 2009 may be summarised as follows:
- Only 27% of the \$14.4 billion increase was anticipated by the actuarial valuation in 2004.
  - Another 33% of the increase was outside the control of management, being due to changes in accounting standards, economic factors and legislation. These included:
    - changes to accounting standards, primarily the adoption of the 75% risk margin (see section 5)
    - changes to the discount rate used in the valuation (as risk free rates fell during the global financial crisis)
    - changes to the scope of entitlements resulting from legislation and court decisions.
  - The remaining 40 percent of the increase (\$5.8 billion) was the unanticipated cost increase for social rehabilitation, weekly compensation and medical costs. The drivers for this increase in costs were: the increasing number of new claims, the lengthening duration of claims, and increases in claim costs above inflation. These factors were, to a significant extent, within the power of the ACC to manage (inflation in medical treatment costs perhaps being an exception).
  - The contribution of new programmes and legislation was significant in financial terms (\$600 million) but a minor proportion of the overall increase in outstanding claims liability.
  - Social rehabilitation is overwhelmingly the most important single contributor to the increase in outstanding claims liability, representing 32% of the total, and 22% of the \$5.8 billion unanticipated increase in liabilities.
- 445 Rehabilitation rates deteriorated across the Scheme in all Accounts over the period 2004-2009. This had large impacts on ACC's bottom line as it meant claimants were staying on the Scheme longer and costing more than was expected when levies were set in the past. The recent reversal in this trend under the current Board and management of ACC, together with the relatively high rehabilitation rates achieved from 2002-2003

demonstrate the very substantial benefits that can be obtained in the Scheme from a strong focus on effective and efficient rehabilitation programmes. However, the history of the ACC Scheme suggests that without structural reforms this improved level of performance will not be sustainable.

- 446 The unanticipated increase in outstanding claims liabilities of \$5.8 billion between 2004 and 2009 dwarfs the losses incurred by any other New Zealand financial institution over the past three years and represents an unacceptable failure of governance, regulation and monitoring. But it would be incorrect to attribute unanticipated cost increases solely to a failure of management, governance and monitoring. Cost increases of this magnitude could only occur in the presence of the systemic weaknesses of the scheme that we have identified.
- 447 The current structure of levies for the ACC Scheme incorporates inefficiently high levels of cross-subsidisation that are impacting on the financial performance and value for money provided by the Scheme. There are a wide range of options to introduce risk and experience rating beyond the minimal levels that currently apply to the Scheme.
- 448 We consider that the introduction of a minimum co-payment is worthy of more detailed examination, both as a reasonable approach to sharing the burden of the ACC, and as a means of removing the current incentives to report that injuries result from accidents.
- 449 The Partnership Programme is an example of a programme that enhances efficiency in insurance markets, and that ACC has adopted from the private insurance sector. However, its implementation by ACC is flawed, in part because ACC faces no competitive pressure to ensure that the Partnership Programme works at the optimal level to provide employers with incentives to invest in safer workplaces.
- 450 Governance, regulation and monitoring of the ACC can be made more effective. Clearer objectives for ACC management that are more tightly linked to the achievement of the performance targets incorporated into the actuarial valuation, and a focus on ensuring that persons appointed to the ACC Board have experience, expertise and sufficient time to be directors of a large and complex insurance organisation will all be of assistance. Monitoring of the ACC by government departments must be more timely, and involve independent analysis of performance by staff with an understanding of financial institutions. Reconstituting the ACC as a State-Owned Enterprise with explicit equity capital and the power to set levies (subject to regulatory oversight) would improve the ability of Ministers to hold the Board and management accountable for the overall performance of the Scheme.
- 451 Improvement in service provision, especially the management of long-term claims, will have the greatest impact on value for money from the ACC. This will arise if ACC is required to focus its efforts much more strongly on early intervention and improving rehabilitation rates, and in particular, on raising return to work rates in the first three months following the injury. This should be seen as part of the full range of changes that

we have recommended, all of which will assist in reducing the 'entitlement culture' currently associated with ACC and returning to a focus on rehabilitation and compensation of actual losses resulting from accidents.

- 452 Fully-funded premiums to cover accidents that have not yet occurred are required to achieve efficient and sustainable outcomes in an insurance scheme even though pay-as-you-go funding is common for social welfare schemes. Fully-funded premiums are efficient in the sense that they provide for a clearer link between the accident experience today and the premiums that are being paid. Fully-funded premiums avoid the inefficiency of departures from actuarially fair pricing and ensure that government and levy payers must face up to the true cost of any changes to the scope or entitlements in the Scheme.
- 453 Proponents of pay-as-you-go levies to cover accidents that have not yet occurred do not address issues of efficiency in the ACC Scheme, and in particular, do not address the costs arising from the setting of pay-as-you-go levies at rates that do not reflect the cost of the injuries occurring in any period, in any Account, or in any industry.
- 454 The investment strategy of the ACC has been successful to date. The Steering Group does not support any direct political intervention in the investment policy of the ACC, and in particular considers that any direction to invest in ways that supported government economic development strategies would have the potential to impair the financial stability of the Scheme.
- 455 The decision of the Board of the ACC to operate within general public sector accounting guidelines by adopting a 75 percent risk margin in the valuation of the liabilities should be endorsed. The presence of an implicit government guarantee or the ability to impose levies for past unfunded liability are relevant to the solvency of the ACC because they bear on the likelihood of having assets sufficient to meet the outstanding claims liability, but they are not relevant to the valuation and the variance of the outstanding claims liability, and it is the latter that the risk margin addresses.
- 456 A variety of improvements to the efficiency of the Scheme have been introduced in the past 18 months and others could be introduced. But the problems that gave rise to this Stocktake flow most fundamentally from the fact that the current structure of the Scheme is inefficient and unsustainable in the long run. Without fundamental structural change to the Scheme, the inefficiency resulting from the cycle of unanticipated cost increases that create large unfunded liabilities for past claims, followed by substantial increases in levies or taxes to fund those costs from past accidents, will continue. We have offered a wide range of recommendations about opportunities for improvements even if the current structure of the Scheme is retained, but the context within which we make these recommendations is important. Our recommendations fall largely into the category of explicit recognition that the accident compensation scheme is an insurance scheme, and shifting it to a basis of efficient insurance. In making these recommendations we are in effect recommending that the Scheme be put on a basis that mirrors the efficient practices

of the insurance industry as closely as possible and as closely as is practicable given state monopoly delivery.

- 457 In this context the importance of the analysis provided in Part B flows from the fact that if competitive private delivery of accident compensation benefits is feasible, then the conclusions of Part A really just amount to an explanation of the benefits of doing so. In other words, the recommendations of Part A are very much second best in that they outline the ways in which the efficiency, effectiveness, and value for money provided by the current Scheme may be improved. If fully implemented, these recommendations would improve the performance of the existing Scheme and allow the ACC to mimic the practices of the insurance industry. But without the benefits of competitive pressure there would still remain substantial doubts about the extent to which levy payers and claimants would benefit from the reforms in the longer term.
- 458 Part B therefore considers the introduction of competitive private delivery as a structural solution to these problems.

## Part B: The Merits and Feasibility of Competition

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### 10 Introduction to Part B

459 Part B looks at the merits and feasibility of introducing competition as a structural solution to the current problems of the ACC Scheme.

460 We have defined “competition” to mean competing private sector delivery of the benefits and services currently provided by the ACC. Further, we assume that for competitive private delivery to be feasible in a New Zealand context it must be consistent with:

- a continuation of the prohibition on common law tort liability in respect of personal injury caused by accidents
- statutory provision for compulsory cover for personal injuries caused by accidents.

461 In examining the feasibility of competing private delivery we have chosen not to focus narrowly on issues relating to the ACC Work Account. The views we express are directly relevant to that Account, but to other ACC Accounts as well.

462 Part B begins with an analysis of the costs and benefits of public monopoly and private competitive delivery of ACC. In section 11 we address the costs and benefits of monopoly public delivery of accident compensation benefits. We outline the benefits that a competitive market might provide in respect of both underwriting and claims management, and we consider whether there are any distinctive features of the accident compensation regime in New Zealand that provide any advantage to, or requirement for, state monopoly delivery. Section 11 also considers the views of the Woodhouse Report and the Law Commission on competitive private delivery, and the reasons why they were opposed to it.

463 Section 12 considers the question of whether competing private delivery will increase the costs of the ACC Scheme to those who are insured by it, and to New Zealand society as a whole. This section considers the costs of competition, the costs of providing for a return on equity invested, and the potential costs arising from any need for specific regulation of aspects of the structure and operation of the market.

464 In section 13 we consider the different ACC Accounts and provide an assessment of the feasibility of introducing competing private delivery into those Accounts over relatively short timeframes. We also outline the work that would need to be done to make competing private delivery of accident compensation feasible in New Zealand and the timeframes over which it might be feasible to complete that work.

465 In section 14 we provide the conclusions to Part B of the report, and in particular provide our assessment of the extent to which the introduction of competitive private delivery will address the policy issues set out in section 1 of the report.

## 11 Public monopoly versus competitive private delivery of ACC: cost and benefits

### Introduction

- 466 Drawing comparisons on the performance of different compulsory accident compensation schemes is complex and invariably involves subjective as well as empirical analysis. Even within schemes of the same type, the details of the regulatory regime within which the scheme operates will have a substantial impact on scheme performance. Factors outside scheme design, including different industrial structures, different proportions of employees in large and small firms, and the benefits provided by the public health and social welfare systems will also affect claim and rehabilitation rates and thus scheme performance. Consequently it is not possible, on the basis of information provided in large international surveys of accident compensation systems, to identify clearly whether public monopoly or competitive private delivery systems have superior performance.
- 467 In this section of our report we therefore attempt to provide a more structured analysis of the potential costs and benefits of public monopoly and competitive private delivery of accident compensation.

### Competition and monopoly in insurance markets

- 468 Competitive markets are those in which rivalry between firms limits the ability of any individual firm to sell its products at prices that would earn more than the competitive rate of return on capital invested in the development and delivery of these products. Competition occurs in many dimensions including price, product specification, new product development, and service levels. Competitive markets thus provide benefits to consumers because rivalry between firms provides consumers with choice in the product specification and service level obtained, as well as limiting the price to the level that provides an appropriate risk-adjusted return on the capital invested by the owners of the firm.
- 469 Monopolies do not face pressure from rival firms to provide either competitive prices or to develop innovations in service and product design. The oversight of regulators (or of officials and political processes where the monopoly is state-owned) cannot provide pressure on the monopoly that is comparable to a competitive environment. This is in part because it is the diversity of decision-making in a competitive environment, and the strong incentives for managers of competitive firms to attract customers away from their rivals, that ensure the existence of diversity in products and service levels and prices set at the competitive level.
- 470 A state monopoly is the ultimate form of centralised decision-making, and fits comfortably with mandatory purchase and an absence of choice in the level and scope of the insurance obtained. There are, however, two major problems with this. First, monopolists are not

endowed with a monopoly on wisdom – their choices are binding on the whole of society, and if the choices made are inefficient the social costs may be extremely high. Second, monopolies remove the potential for consumer preferences to be met through the diversity of decision-making that is associated with competition. This means, for example, that advocates for higher levels of benefits for injured workers are required to argue that the benefits available to everyone in society should be raised, whereas under competition the option would be available for workers to bargain with their employer to have higher levels of cover if they preferred that to wage increases with equivalent costs. Competition offers consumers a menu of choices of types and levels of cover, of service levels, and of premiums, and the ability to choose the best match for each individual consumer in each of these dimensions is a key component of the efficiency of competition. A public monopoly can attempt to use strategic direction and performance monitoring by its board, its stakeholders, and officials from other parts of the public sector as a stimulus to generate levels of responsiveness similar to those that would be provided by competing private firms, but the effectiveness of these mechanisms is limited in practice.

- 471 The design of insurance products represents a key element of competition in insurance markets, and this may take several forms. Insurance products may bundle together cover for different types of risk where they can identify either common elements in the determinants of risk or savings in administration costs from this approach. Insurance products may also offer different levels of cover, allowing consumers choice in the cover they obtain. And insurance products may be designed to elicit private information from the consumer about the likelihood of the contingency insured against actually occurring.
- 472 For the purposes of this report we have assumed that a competitive market for accident compensation insurance in New Zealand would be associated with the specification of a minimum level of cover that must be purchased by all firms or individuals in respect of particular risks. This would reduce some of the scope for competition by ruling out offers of, and consumer preference for, products and levels of service below the statutory minimum. It would also reduce the price discovery benefit. However, wide scope for competition in service levels, claims management, and approaches to rehabilitation would still exist, and consumers would obtain the benefits of price differentiation between insurers. In addition, and perhaps more importantly, despite the assumed statutory minimum level of cover, wide scope for competition still exists in respect of purchase of insurance above the minimum entitlement, the bundling of different types of accident products, and the bundling of accident and non-accident insurance products to cover, for example, incapacity resulting from both health and accident, and collision and personal injury automobile insurance.

### **Do the Woodhouse “principles” require state monopoly provision?**

- 473 We noted in section 2 that the Woodhouse Report described five principles on which the New Zealand accident compensation scheme should be based: community responsibility,

comprehensive entitlement, complete rehabilitation, real compensation, and administrative efficiency. Here we consider whether, when interpreted in a modern context, these principles require state monopoly delivery of accident compensation services.

- 474 The principle of community responsibility was interpreted by the authors of the Woodhouse Report to mean that all members of the community should accept responsibility for meeting the costs of incapacity resulting from accidents, and share equally in meeting these costs. However, in practice this interpretation of community responsibility has never been implemented, as successive governments in New Zealand have maintained a separation of different Accounts within the ACC Scheme as well as modest differentials in levy rates within them. This practice reflects recognition that the risk of accidents varies across firms, and across the different activities covered by the Earners' and Motor Vehicle Accounts. In practice, therefore, community responsibility has been interpreted as requiring a compulsory and comprehensive scheme that covers all members of the Scheme, not as requiring that all members of the community contribute equally to the cost of every accident. This means that this principle is consistent with having a compulsory comprehensive scheme with benefits above the general welfare system, which is delivered (in whole or in part) by competing private insurers.
- 475 The other principles enunciated in the Woodhouse Report also appear to be entirely consistent with competitive private delivery in the presence of compulsory purchase and basic contractual requirements that could be incorporated in the minimum provisions for a private contract. However, the principle of administrative efficiency deserves greater attention since it appears that in this principle the authors of the Woodhouse Report intended to capture what they saw as the wasteful expenditure of insurance companies on competition for business, differential premiums reflecting the risk of accidents, and a return on the equity invested by shareholders of the insurance firms. We address these issues more fully in subsequent sections of this report, but for now we note that we think that administrative efficiency is more likely to be generated by competitive pressure among insurers to provide services to the insured parties and claimants, than by a state monopoly with opaque performance measures and limited monitoring by officials.
- 476 Finally we note that one important principle appears to be missing from this list – the need to provide strong incentives for investment in accident prevention, rehabilitation, and return to work. By focusing on the need to remove consideration of the cause of accidents (in the form of common law claims of negligence) the Woodhouse Report omitted substantial consideration of the incentives and mechanisms for prevention and rehabilitation. All modern compulsory accident compensation regimes provide a strong focus on incentives of this type. The approach of private sector insurers in providing these incentives through risk and experience rating of premiums is noted in Sections 3 and 8.

## The Woodhouse Report and the Law Commission on competitive private delivery

477 The Woodhouse Report was categorical in its rejection of the involvement of competing private insurers in the accident compensation scheme, as was the comprehensive review of the ACC Scheme completed by the Law Commission in 1988. Below we provide a précis of the different arguments against private competitive delivery offered in these two sources, and our assessment of the merits of these arguments in a contemporary context. This analysis is based on five propositions advanced by the Woodhouse Report and the Law Commission.

478 **Proposition 1:** *“Private insurers can have no claim to handle a fund such as the compulsory fund in New Zealand which has arisen not because employers have been persuaded to provide the business, but because Parliament has ordained that employers must do so.”<sup>41</sup>*

The Steering Group considers that a legislative requirement for participation in the accident compensation scheme does not in itself rule out the involvement of private insurers.

479 Compulsion in the purchase of insurance does not affect the ability of the private insurance industry to underwrite the risks associated with the insurance – indeed it makes underwriting easier by removing the potential for the best risks to opt out of the market. Similarly, the terminology of levies appropriate for a compulsory scheme is different from the terminology of the premium provided in private insurance contracts, but the difference is one of language rather than substance. Compulsory levies may provide a rationale for the claim that ACC should be treated as social welfare but they do not in any way remove the underlying insurance function of the ACC Scheme.

480 There is therefore an important distinction between a statutory requirement to purchase insurance and the statutory “gift” of profits to the shareholders of any individual insurer. In our view compulsion does not gift business to any individual insurers: so long as there are competing insurers in the market and the credible threat of entry from new insurers, employers must still be persuaded to provide their business to any individual company. An inefficient company cannot obtain a share of the business by right or just by participating in the market. This conclusion is reinforced if self-insurance is possible and/or if there is a state-owned insurer operating in the market, since in these circumstances there will be no guarantee that any private insurer will obtain a share of the market.

481 **Proposition 2:** Statutory removal of tort liability for any party causing through negligence the injury sustained is inconsistent with the adversarial approach of insurers and their focus on insuring against tort liabilities before the ACC Scheme was introduced: *“If this is*

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41 Royal Commission of Inquiry into Compensation for Personal Injury (1967) p.88.

*an insurance scheme, what is it that the payers are insuring against? They no longer have civil liability for personal injury”.*<sup>42</sup>

Although it is true that disputes relating to eligibility and liability were a feature of the insurance and legal regime that operated at the time that the Woodhouse Report was written, they are not a necessary feature of provision by private insurers. The absence of an adversarial system has implications for the incentives in any compulsory scheme and for the pricing of the cover provided by insurers, but it does not undermine the fundamental concept of insurance.

482 The views of the Law Commission appear to reflect a misunderstanding of the role of insurance. The fact that it is possible to take out insurance only completely transfers risk in a world in which there is no co-insurance payment and no rating of premiums on the basis of the record of the insured party. In practice the accident compensation scheme includes a co-insurance component (through less than complete compensation for lost income) and (despite the recommendations of the Woodhouse Report) again has always included some risk-rating of the premiums paid by different parties (for example, different types of employers, and different types of motor vehicles).

483 **Proposition 3:** *“The insurance system in itself can offer no central impetus in the important areas of accident prevention and rehabilitation”.*<sup>43</sup>

The incentives for employers or other insured parties to invest in accident prevention when they are covered by a compulsory no-fault compensation scheme arises from two sources: the cost of recruiting and training staff injured in accidents, and the cost of the premium or levy that they pay for insurance cover. Since the costs of recruiting and training cannot be controlled by the compensation scheme, considerable weight attaches to the extent to which the premium or levy penalises high accident rates and provides direct financial incentives for the insured parties to invest in mitigation of accident risk, rehabilitation, and early return to work.

484 In this sense, a key weakness of the scheme outlined in the Woodhouse Report was the complete absence of any attention to financial incentives for accident prevention and recovery. Despite the introduction of some risk-rating into the ACC Scheme, the lack of financial incentives for accident prevention and recovery continue to be a key weakness. In contrast, private insurers are driven by competition to use risk categories and experience rating to offer premiums that do promote accident prevention and recovery, rewarding positive experience and penalising high or higher than expected accident rates, and are largely free of implicit political constraints on their ability to set premiums that fairly reflect the loss experience. Our view, therefore, is that a private insurance approach

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42 Law Commission (1988) p.72

43 Royal Commission of Inquiry into Compensation for Personal Injury (1967) p.181.

to accident compensation is more likely to provide impetus to accident prevention and rehabilitation than the scheme that the Woodhouse report envisaged.

485 **Proposition 4:** The ...insurance industry “wishes to be able to negotiate the terms of its obligations and to decide whether to insure a particular person or not”.<sup>44</sup>

The Steering Group recognises that schemes of compulsory insurance involving private insurers require that consideration be given to the issues that will arise when actuarially fair premiums for high risk groups are not affordable for some members of those groups. One option is that limitations can be placed on the ability of insurers to decline to offer insurance cover to any firm or individual and ceilings can be placed on the premiums that insurers are permitted to charge. Such restrictions would affect the average price at which insurance will be available to parties in the market (since the inability of insurers to decline to insure the worst risks will affect premiums across the market), and are inconsistent with the principle that subsidies from government should be transparent and minimise adverse incentive effects. An alternative and preferable option is that where there is deemed to be a net social benefit from allowing activity to occur where the insured party cannot afford the premium, government may fund a direct subsidy for that group. Neither option precludes competing private delivery of accident insurance.

486 **Proposition 5:** The insurance industry would not “contemplate taking a responsibility for earnings related compensation which would extend over more than a year or two”.<sup>45</sup>

There is no factual basis for this contention, which even in the context of earlier times demonstrates a lack of knowledge of the business of the private insurance industry. Dealing with long-term claims liabilities, classically through the provision of annuities (annual payments equivalent in present value terms to a lump sum payment) has been a standard feature of insurance services since the first formal insurance companies emerged over 250 years ago. Today, income replacement policies offered by competing private insurers and providing benefits for as long as the loss of income continues are commonly purchased as a “top-up” to ACC benefits.

487 The Woodhouse Commission recognised the economies of scope between accident and other types of insurance that had been drawn into stark relief by the short experiment with monopoly delivery by the State Insurance Office from 1949 to 1951, and responded to this not by allowing the competing private insurers to offer both compulsory and discretionary lines of insurance, but by recommending state monopoly provision by an

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44 Law Commission (1988) p.72

45 Ibid at p.73

agency that is prohibited from writing other lines of insurance.<sup>46</sup> The Commission elucidated a number of arguments against private delivery, some of which would raise issues that should be considered in the design of a scheme with competitive private delivery but none of which represent credible arguments for prohibiting competitive private delivery. Thus we have formed the view that there is nothing in the reports of the Royal Commission of 1967 or the Law Commission of 1988 that could in the modern context be considered to be credible arguments against competitive private delivery.

## Is public monopoly delivery of accident insurance justified?

488 Markets are vehicles for the allocation of resources. The formal economic characterisation of competitive markets is that they are characterised by voluntary exchange of property rights over goods and services in an environment where prices reflect relevant information and social costs of production as well as rivalry between buyers and sellers. Market failure may arise where some feature of the market precludes efficient private delivery of goods and services. Economic theory recognises that market failure may occur for three reasons:

- insufficient markets
- lack of competition between buyers and sellers
- the absence of a competitive equilibrium in markets.

489 Many responses to perceived failure of markets fall into the category of creating more markets, through vehicles such as futures markets and options contracts, through the assignment of or protection of property rights. Lack of competition between buyers and sellers is often addressed by competition and securities market regulation as well as by consumer protection laws. The absence of competitive equilibrium may arise where there is a “natural monopoly”<sup>47</sup> or where there are information, adverse selection or externality problems<sup>48</sup> that are so severe as to inhibit efficient resource allocation. Most of the arguments that might be advanced to justify monopoly state delivery of accident insurance in New Zealand fall into the last category, and we consider these in more detail below.

490 Monopoly state provision of accident compensation insurance has the effect of creating a very large insurance organisation, and it is sometimes argued that consumers receive

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46 The Woodhouse Report notes that the reason for the repeal of the monopoly privilege “...probably lay in the fact that the State insurance Office was a competitor of the other companies in all the remaining areas of insurance business, and by many it was considered unfair that it should be put in the position of being able to attract these other types of insurance business ... by reason of the fact that every employer in the country had willy nilly become its customer”. Para 183 p.80.

47 A natural monopoly arises where economies of scale are so important that a single producer in a market can offer goods or services at prices lower than the prices that could be offered by any two or more producers.

48 Externalities arise where there are costs associated with the operation of a market that are not reflected in the prices that are negotiated in the market (normally because there is no mechanism to require buyers or sellers to consider or reflect these costs in their decisions).

benefits from economies of scale in the provision of insurance services. This is particularly the case in New Zealand, where the ACC has levy (premium) income many times larger than any private insurer currently operating in the market. A single provider allows for the operation of one information management system for the whole market, ensuring ease of co-ordination of claims and payments across all aspects of the system including the services provided by medical practitioners. This could be efficient if it reflected a response to a natural monopoly problem in New Zealand insurance markets.

- 491 There is, however, no compelling evidence that New Zealand insurance markets are characterised by natural monopoly problems, or that state monopoly provision is the optimum response to the economies of scale that do exist. Even if there are scale economies to be achieved by consolidating a single firm up to the size of the whole market, the benefits of market competition in providing benefits to consumers in different market niches and through the introduction of product and service innovation normally make monopoly provision unsustainable. In addition, economies of scale can be achieved across different lines of insurance and across markets in different jurisdictions (including through reinsurance), as is demonstrated by the operations of insurance companies in the private sector and the operations of competing private insurers in accident compensation markets overseas.
- 492 If there are specific fixed costs that are market wide eg, a single information clearing system, such a system could be established for the use of all private insurers offering compulsory accident cover, either as a joint venture of the insurers or through a third party provider.<sup>49</sup> We note that whatever benefits it achieves through economies of scale in relation to accident insurance, the ACC is denied the economies of scope across all related lines of insurance against death, injury and loss of income from illness and other causes that are not accidental, and from market demand for insurance in excess of the statutory cover that would normally be available to private insurers. Even within the context of the current ACC Scheme, self insurance and service provision by third party administrators effectively illustrate the importance of factors other than scale economies in determining the most efficient organisation of the market. The steering group therefore considers that economies of scale do not establish a case for monopoly provision of accident compensation insurance.
- 493 Insurance markets also have the potential to exhibit market failure if the private information or adverse selection problems are so severe as to make private contracting inefficient. In the case of accident insurance, it is possible to argue that a key problem is that two different types of self-selection may inhibit the efficient operation of markets. One type of self-selection involves those who are low risk choosing to self-insure, leaving

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49 The banking industry provides an example of this approach in its creation of transaction, clearing, and settlement systems that provide services to all banks operating in the relevant market.

insurers with only those who are high risk as insured parties. However, this type of self-selection is present in all insurance markets and is not a barrier to efficient private delivery of insurance. A second type of self-selection arises in New Zealand from the situation where those who are more likely to cause accidents choose not to insure and attempt to free-ride on the social welfare and no-fault accident regime. This issue is addressed by making insurance compulsory, and does not require monopoly provision of the insurance.

- 494 The claims associated with accident compensation insurance are potentially of very long duration because permanent disability resulting from an accident requires the payment of benefits for the remainder of the life of the disabled person. It is sometimes suggested that private insurers are not appropriate vehicles for the management of these claims, since private insurers may become insolvent and since the value of these claims, and thus the reserves required to fund them, can only be estimated at a point in time. However, private insurers have equity reserves to act as a buffer against the prospect of underestimation of reserves, and the insurance risk can be reinsured in the global reinsurance market. New Zealanders hold a substantial portion of their savings in banks that are also subject to failure and that even recently have benefited from government support during a period of financial crisis, but risk of insolvency and the need for government support in a crisis do not make a case for monopoly state provision in banking or in insurance. The steering group considers that an appropriate prudential supervision regime can effectively limit the potential for private insurance companies to underestimate required reserves, or to become insolvent, and thus it does not consider that the long duration of claims requires a state provider of insurance.
- 495 Competitive markets rarely provide for stable prices over a long period of time unless the market is characterised by collusion between the competitors or by 'perfect competition' in which there is no differentiation between the cost structures and the products of the competitors. Fluctuations in the prices observed in a competitive market occur in response to changes in market conditions, particularly the desire of insurers to increase market share by offering customers lower prices and/or higher quality services. Markets in which regulation limits price and service level competition and the resulting fluctuations in prices over time deny consumers the full benefits of the competitive process. The recent history of the ACC Scheme and the public monopoly schemes in Victoria, New South Wales, and South Australia<sup>50</sup> demonstrates that state monopoly providers of accident compensation insurance are prone to respond to political pressure to keep premiums stable even though inflation and new benefits are substantially increasing liabilities, with the result that these schemes are also prone to price instability.
- 496 In the case of the ACC Scheme monopoly provision has also been justified by the claim that it is a social insurance or social welfare scheme rather than an insurance scheme of the

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50 Australian Government, Productivity Commission (2004) p.317.

type offered by the private sector. We have addressed this claim in Section 3 above, but here it is worth noting one further aspect of the support for viewing ACC as a state monopoly social insurance scheme: that if the scheme is required to impose substantial cross-subsidies on different groups of levy payers, then state monopoly provision will be necessary to stop those paying the cross-subsidies from exiting the scheme and obtaining their insurance from a provider that does not require them to cross-subsidise other participants. Supporters of state monopoly provision of accident insurance in New Zealand will therefore include those who expect to be able to obtain private benefits from cross-subsidies, or from avoidance of fully-funded premiums, which the scheme imposes on other levy payers today or in the future. But this is not a market failure rationale for state monopoly provision – indeed it is a private interest rationale that imposes inefficiency where it need not be present.

### Benefits of private ownership discipline

- 497 We noted in section 7 above that the governance and monitoring problems associated with the ACC are severe, and will be difficult to solve so long as it is a Crown Agent. Monitoring by government departments is unlikely to be able to replicate the focus or timeliness of monitoring of private firms with publicly traded equity, and the competition of complex and potentially contradictory objectives and Ministerial discretion on levies substantially reduces the accountability of the Board and management.
- 498 In contrast, competing private delivery of insurance provides benefits for the operation of a compulsory insurance market by ensuring that the discipline provided by private ownership is imposed on the activities of firms in this market. Discipline arises from the fact that the equity investors in private insurance firms are residual claimants on the activities of the firm. This ensures that equity investors have a strong incentive to monitor the activities of the managers of insurance firms. Recent events in financial markets have demonstrated that these incentives cannot always ensure that insurance firms operate in an efficient way, but this does not detract from the observation that the monitoring by shareholders with personal wealth at stake is likely to be more intense than monitoring by officials and politicians who can utilise the power to tax to make up for losses resulting from inefficient management.
- 499 Private ownership also provides discipline because of the way in which the market for corporate control provides a vehicle for the transfer of ownership rights. Investment analysts and potential investors contribute to the monitoring effort, and if the performance of the management or the board of the firm is considered to be deficient this creates an opportunity for investors to profit from acquiring a controlling stake in the firm and introducing more efficient management.
- 500 The incentives provided by private ownership, combined with competitive pressure from multiple insurers, also have the effect of encouraging the identification of the most

efficient approaches to underwriting and claims management. Politically motivated constraints on the setting of high premiums for high-risk parties will not be sustainable in competitive markets because of the business opportunities that arise from the identification of lower risk parties and the offer to them of lower premiums.

## Constraints of a compulsory minimum cover for a competitive process

- 501 The structure of the compulsory cover has implications for the other insurance products written in the market, as we have pointed out above. But in addition, compulsory minimum cover requirements limit the ability of firms and individuals to make rational choices about self-insurance in several dimensions. For example, it is not clear why the government would require every employer and earner to purchase insurance that pays for all initial costs of an accident, including the first visit to the doctor, when many firms, self-employed persons, and individual earners would prefer a lower premium in return for self-insuring in these respects. Maximising the scope for self-insurance, not just for firms meeting minimum prudential requirements, but possibly also for self-employed individuals with minimum levels of personal wealth, would reduce the impact of these provisions and maximise the opportunity for private insurers to offer innovative responses to the statutory requirements.
- 502 Competing private insurers can therefore provide insurance with compulsory minimum cover requirements, but the greater the constraints provided by the specification of minimum cover levels, the more limited is the scope for society to obtain the benefits of the product diversity and innovation that are normally associated with competing private delivery of insurance.

## Conclusion

- 503 The Steering Group has concluded that there is no compelling rationale in insurance practice or arising from market failure for delivery of accident compensation insurance through a monopoly state-owned entity such as the ACC.
- 504 Because it is primarily a compulsory insurance programme, rather than a social welfare scheme, the ACC Scheme will benefit from the expertise and technology of the private sector in the delivery of accident compensation services. The retention by the government of the power to determine the scope of, and benefits provided by, the ACC Scheme, and to enforce compulsion in the payment of levies, is sufficient to deal with the legitimate interests of the Crown in the ACC scheme. The potential for “free-riding” on the welfare system by those who choose not to take insurance is addressed by making the purchase of insurance compulsory, but compulsion does not require monopoly delivery.
- 505 Within the context of a compulsory scheme, efficiency can be improved by maximising the range of options available to the insured parties, for example experience rating and self-

insurance. In addition, reducing the transaction costs imposed on those who wish to obtain higher levels of cover will also improve efficiency. A key benefit of these schemes is that they encourage employers and their staff to take ownership of the risk associated with accidents, and to take seriously the benefits of investment in accident prevention. Private competitive delivery is likely to be more effective than a state monopoly in providing these options to consumers.

506 Our conclusions on the feasibility of private delivery of compulsory accident insurance are consistent with the evidence that we have obtained about the practices adopted internationally (Appendix 1). In a wide range of different countries there are examples of competitive private delivery models for compulsory workplace accident insurance that are effective and have exhibited stability over time. Competitive private delivery regimes range from those where regulation of the markets and the rates charged by the private insurers is limited, to those that impose a complex regulatory framework on the operation of the workers' compensation insurance market, and those where publicly owned insurers are allocated particular market niches or compete with the private sector. For compulsory personal injury and third party motor vehicle insurance, competitive private delivery is overwhelmingly the most common delivery model used in other countries.

## 12 What impact will competitive private delivery have on premiums?

### Introduction

- 507 Some views expressed to the Steering Group were that a key advantage of the ACC Scheme over competitive private delivery is that the premiums set under state monopoly provision will be lower than those that will apply under competitive private delivery. The claim often rests on a view that the requirement to fund both private equity in the insurance companies and competition between these companies will increase premiums, and on a failure to inquire into the value that these aspects of private insurance provide to consumers.
- 508 In this section we consider a range of issues relating to the cost of competitive private delivery for consumers and the Crown. We begin by looking at the available evidence on premiums across the transition from public monopoly to competitive private delivery, and then consider why that evidence suggests that competitive private delivery does not result in higher premiums than public monopoly provision.

### Comparability of premiums under public monopoly and competitive private delivery

- 509 Australia and New Zealand provide three recent examples of the impact on premiums of the move from public monopoly to competitive private underwriting and service delivery, in situations where the public monopoly provider had been setting actuarially fair fully funded premiums immediately before the introduction of competition.
- i When competitive private delivery for the Work Account was introduced in New Zealand in 1999 the premiums paid by most firms and self-employed persons were lower than the levies that they had paid to the ACC Scheme in the previous year. Only for some small firms was there an increase in the premiums that they were required to pay. The steering group is aware of claims that the premiums charged by the competing private insurers reflected loss-leading and would not have been sustainable over time. However, the steering group considers this claim to be implausible for two reasons. First, entry to the market was open, so potential entry by new firms that did not sustain losses in the first year would maintain future premiums near the actuarially fair level. Second, the steering group has been provided with a copy of independent actuarial evaluation of the pricing strategies of the insurers completed after the Work Account was returned to ACC. This review suggests that on the claims experience of 1999 the premiums charged by the competing insurers were sustainable, and that in some parts of the market the claims experience was sufficiently positive as to suggest that competition would have forced premiums down in subsequent years.
  - ii When competitive private delivery was introduced for the New South Wales Personal Injury Motor Scheme in 1989, and premiums were deregulated in 1991, the

average premium fell substantially below the premium set under state monopoly provision for several years, increased sharply as a result of poor claims experience, and then fell to below the level set under public monopoly. The average premium charged under competitive delivery over the period 1991 – 2009 is (even in nominal terms) below the levy set under monopoly state provision in 1989.

- iii When competitive private delivery was introduced into the New South Wales home warranty insurance scheme in 1997 the premiums charged fell substantially from the levels set under monopoly state provision.

510 We have therefore concluded that where we have been able to obtain evidence on the premiums charged before and after the transition from public monopoly to competitive private provision, and where the premiums being set under monopoly provision were at the fully-funded level, the evidence is that premiums did not increase overall. However, premiums could increase for some risk pools among the insured, since part of the improvement in efficiency provided by competitive private delivery results from more accurate assessment of risk pools and the actuarially fair premiums associated with them.

### Comparability of premiums in competitive Australian workers' compensation schemes with the levies of the ACC Scheme

511 The levies and premiums associated with the workers' compensation schemes in Australia, including in those schemes with competitive private delivery, appear to be substantially higher than the levies associated with the ACC Work Account. The Steering Group therefore commissioned comparative actuarial analysis of the premiums charged in the Australian workers compensation schemes and those set by ACC. Due to limitations on the availability of data necessary for the preparation of a robust comparison, this analysis was confined to one scheme with competitive private delivery (Western Australia) and one scheme with public monopoly underwriting (New South Wales).

512 Comparison of the premium rates requires that they be normalised for a number of key differences between the schemes. The most important of these may be summarised as follows:

- **Industry mix:** premiums vary across different risk pools, so the average premium or levy reflects the weight of high risk and low risk industries in each scheme.
- **Insurer discounts:** in Western Australia (but not in the public schemes) competition results in discounting of the published rates so that actual rates paid are at least 17.5% lower.
- **Coverage:** the range of accidents and disabilities associated with the workplace that are covered by the scheme, particularly the impact of the Western Australian Scheme having a broader coverage of stress claims than the ACC Scheme.
- **Benefits:** the benefits paid in the event of an accident, particularly more generous weekly compensation coverage and the ability to seek common law redress rather

than accept the statutory level of benefits in Western Australia. Common law claims are not permitted in the New South Wales scheme.

- **Actuarially fair premiums:** the premiums set must be based on actuarial analysis of past claims experience and be consistent with the accounting standards and practice of private sector insurers.

513 No attempt was made to address the complex issues that arise in considering the differing incentives in these schemes as a result of differences in the benefits provided, and the fact that incentives to claim on workers' compensation schemes in Australia may be stronger than the incentive to claim on the Work Account in New Zealand because New Zealand provides comprehensive coverage for accidents wherever and however they occur.

514 The West Australian scheme has a nominal premium of \$1.74 per \$100 of wages for 2009/2010, compared to the levy for the ACC Work Account, which is currently \$1.02 per \$100 dollars of wages and salaries. After normalisation for the factors outlined above it was not clear that there is a significant difference between the ACC levy and the competitive private delivery premiums in Western Australia. However, the premiums charged by the monopoly provider of workers' compensation insurance in New South Wales do appear to be substantially above the fully funded and actuarially fair Work Account levies of the ACC Scheme.

515 We have therefore concluded that differences in the nature of the schemes account for a substantial part of the difference between the premiums set for workers' compensation schemes in Australia and the ACC Work Account levies. Our evidence suggests that it is not appropriate to conclude that the premiums for workers compensation schemes in Australia are higher where there is competitive private delivery of the insurance, though the premiums appear to be materially higher in at least one case of monopoly public delivery.

## The need to earn a return on equity

516 The equity capital of an insurance company represents the funds that shareholders have at risk in the business of the company. Equity and retained earnings are important because the business of the insurance company is risky and it might not be possible to levy customers or beneficiaries *ex post* to cover cost shortfalls. The insurance company faces uncertainty in respect of its ability to maintain or grow market share in a competitive environment, exogenous 'shocks' to the economic environment that affect the business of the company, and uncertainty about both the true value of the long-term liabilities generated by past claims and the claims that will be generated in the future. The equity capital of a for-profit insurance company can be seen as providing protection for the existing policyholders and the ongoing beneficiaries of past claims against negative shocks to the business of the company that might impair its ability to meet new claims and pay existing claims. This is because the costs of unforeseen events that were not built into the

premiums charged are first written off against the value of shareholder equity rather than the claims of past and current policyholders. Reserves play a similar role for mutual schemes.

- 517 Explicit equity has several advantages. First, it ensures that the most risky investment in the operation of an insurance company is made by those who can efficiently bear that risk – that is, those who choose explicitly to invest in equity capital. In a company without equity capital, or in a mutual company, all policyholders of the company share in the risk. In a state monopoly with no explicit equity the risk of unforeseen events is shared, potentially in ways that are not transparent ex ante and thus are unlikely to be consistent with efficient allocations of the risk, between the insured parties (who may face higher premiums in the future to pay for past losses) or the government (who may be required to increase general taxation revenue, or increase government debt to pay for past losses). Second, the presence of explicit shareholder equity also serves an important purpose in monitoring the performance of the management of any firm. The return on the equity invested by shareholders that is earned by management provides a relatively simple and transparent measure of the performance of the firm at any point in time and across time.
- 518 The ACC Scheme currently operates without equity. The absence of explicit equity would be unusual if the ACC was a state-owned trading enterprise, but as a Crown Agent the absence of equity is perhaps less surprising. Some commentators see the absence of equity in the Scheme as a key advantage of state monopoly provision, echoing the sentiments of the Woodhouse Report that the requirement to generate a return to the shareholders of insurance companies was an unnecessary encumbrance on the accident compensation system. In effect, the claim is that by substituting the power of the government to impose ACC levies, raise general tax rates, or fund the Scheme through government borrowing, the requirement for equity and the costs that are associated with it disappear.
- 519 The problem with this view is that the risk associated with the business of the ACC Scheme that would be carried by the holders of the equity capital in the Scheme does not disappear because there is no equity. Rather, the Crown is using its ability to impose levies on contributors to the Scheme and an implicit government guarantee of its liabilities arising from state ownership as a substitute for the presence of formal equity. This means that we must consider where the risk associated with ACC operations is carried in the absence of equity, and whether this reduces or increases the total cost of the Scheme.
- 520 The recent history of the Scheme makes it clear that funding shortfalls from its past operation will be imposed on current levy payers where there is a direct mechanism for doing so, or funded from general taxation when (and for those Accounts where) there is not. This means that in contrast to the way in which equity investment allocates risk to those who have the capacity to bear it, the absence of equity allocates that risk across current levy and taxpayers equally, including no doubt to many individuals and firms

whose income and assets are small enough as to make it inefficient for them to have to bear that risk. In practice, for example, the Scheme forces all of the small businesses in New Zealand to bear their share of the risk of negative shocks to the income and costs of the ACC, and denies them the choice to insure that risk by allowing equity investors to bear it and receive the market-determined return in compensation.

- 521 This analysis implies that if state monopoly of accident compensation insurance in New Zealand were to continue then the ACC Scheme should have explicit equity provided either by government or a combination of government and the private sector. This would provide two overwhelming advantages: first it would make it clear where the risk of unforeseen losses on existing and past business falls, and it would relieve levy payers of the requirement to bear those risks (albeit at the cost of a requirement to provide a return on the equity).
- 522 The Steering Group has therefore concluded that the assertion that the absence of a formal requirement to earn a return on equity in the current ACC Scheme makes it cheaper for the community than using competing private insurers is incorrect. The risk that is carried by shareholders in private insurance companies does not disappear because the insurance provider is state owned and has no equity. It is carried by society, through the liability of levy payers and the government to meet current claims and the ongoing costs of past claims. This system is inefficient because it imposes on many employers and individuals risk that would be more efficiently allocated to investors in equity shares.

## Marketing and administration expenses

- 523 Competing private insurers have costs associated with competing for customers, distributing their products, and managing claims. Even though the purchase of accident insurance may remain compulsory, marketing and administration costs will be incurred as a result of private providers competing for market share. To the extent that these costs are uniquely associated with a competitive environment they will represent costs that a monopoly state insurer will not incur.
- 524 The marketing and distribution costs of private insurers are an integral part of the competitive process, reducing information asymmetries for purchasers of insurance and enhancing the benefit of competition. The requirement to compete for the business of customers is the key motivation to invest in innovations in product design, the identification of risk pools, and claims management.
- 525 It is not clear that the costs of competition will result in insured parties paying higher premiums. We consider it likely that the benefits resulting from competition between insurers, including reductions in the premiums that need to be paid or improvements in the quality of service provided, will offset the increase in administration costs in the market over and above those of a monopoly provider.

## Variability in levies/premiums across time and risk pools

- 526 The premiums set by competing private insurers from year to year will vary, but it is not clear that they will vary to a greater extent than those set by a monopoly state provider of insurance. Private insurers are required to maintain full funding and thus to set premiums at the actuarially fair level in each year. When claims experience varies from the level predicted in the actuarial valuation private insurers will adjust the premiums that they charge. This has the effect of ensuring that the benefits of improved claims experience are quickly passed on to the insured parties. It also makes premiums more stable across years in the sense that it rules out sudden increases in premiums to cover unfunded liability from the past. In contrast, with public monopoly schemes politicians may make choices to hold premiums below the actuarially fair level in particular years, but then be required to institute very large increases in premiums to cover unfunded liability when the full impact of their choices becomes clear in actuarial valuations.
- 527 Private insurers will never knowingly set the premiums at less than the fully funded rate, because in a competitive market they will not be able to recover those premiums in subsequent years, with the result that under-funding will result directly in losses for their shareholders. Competitive private delivery may therefore be thought of as a means of providing a credible commitment to actuarially fair premiums (without the political setting of premiums) across risk categories and the accident record of the insured party, as well as a commitment to full funding of claims.
- 528 Given the limited extent to which the ACC Scheme currently uses risk pools and the recent re-introduction of powers for the Scheme to use experience rating in legislative changes made earlier this year, it seems certain that the range of premiums charged for accident insurance under a competitive private delivery model will be much wider than it is at present. In particular, we could expect that the cost of accident compensation insurance for high-risk parties will increase under a system of competing private delivery, and concomitantly costs will decrease for the lowest risk parties.
- 529 Experience rating is widely used in both public monopoly and competitive private delivery schemes throughout Australia, and is used as a key component of competition in those jurisdictions with private underwriting and delivery.
- 530 Where high risk parties face substantial increases in the premiums that they must pay to obtain insurance, some will no doubt suggest that the premiums are prohibitively high. The Steering Group has therefore considered whether the government should regulate premiums, and/or require insurers to accept any risk at a regulated maximum premium, and/or create a residual state-owned insurer of high risks at subsidised prices. Our views are consistent with those expressed in the *Report of the 1991 Working Party on Accident Compensation* as follows.

- the high premiums are an important signal about the risk associated with the activity being insured, and an incentive for the insured party to invest in risk mitigation – and this is exactly the outcome that is of value to society
- even if an employer cannot obtain cover, or can only obtain cover at a price that is very high by comparison with the levies historically set by the ACC, that employer should not have automatic access to an assigned risk pool at regulated rates, or to a government-owned residual insurer of high risks
- similarly, if the owner of a motor vehicle wishes to drive but has such a high risk profile that they can only obtain cover that they cannot afford to pay, it should be illegal for them to drive. The insurance premium is a signal that society is better off without that person driving.

531 Regulation of the maximum premium that can be set in different risk classes has two negative implications for the efficiency of the insurance market. The first is that where high risk parties are required to be insured at a premium that is below the actuarially fair level, then the insurance scheme is providing a direct subsidy to risk-taking and no incentive to improve accident experience. If the government considers that the activity is of such high national importance that a subsidy is in the public interest, then that subsidy should be provided directly and not in the form of subsidised accident insurance, since the latter has the perverse effect of providing incentives to risk-taking. Second, if the maximum premium is set by regulation this may provide governments with incentives to attempt to increase benefits provided while holding premiums constant. In a competitive insurance market there can be no ‘monopoly power’ justification for such a policy, and its most likely effect will be to force the withdrawal of private insurers from the market.

### Government autonomy on policy changes relating to compulsory accident insurance

532 The use of a state monopoly provider of underwriting and claims management for accident insurance provides the government with a clearly defined vehicle for the implementation of policy changes relating to the scope of operation of the accident insurance market. The Steering Group has therefore considered the extent to which the introduction of competing private delivery of accident compensation insurance could constrain the government’s ability to implement policy changes relating to this market.

533 In all countries where competing private delivery of accident compensation insurance is in place, the primary vehicle through which changes in policy are implemented by the government of the day is through changes to the law and regulations that set out the minimum insurance cover the participants are required to purchase, and regulate participation in, and operation of, the market. Where issues arise in the operation of these schemes, such as the emergence of previously unforeseen issues that require substantial premium increases, the benefit of a market in which private insurers are participating is that there is a requirement for a transparent discussion about the issues

and possible solutions involving insurers, the insured parties, government, and other stakeholders. One example that has been drawn to our attention is the Personal Motor Injury Scheme in New South Wales, where deterioration in claims experience from 1994 to 1999 was dealt with through legislative changes in 1995 and 1999 that followed transparent reviews involving all participants in the scheme.

534 Thus, in an insurance market where compulsory purchase of a minimum level of cover is established, and a regulatory framework appropriate for a market in which participants are required to participate, there is no evidence that competing private delivery of the insurance would constrain the ability of any government to implement policy changes. Markets that lack a state monopoly provider of the services require a higher level of transparency in the introduction of policy changes, and will produce faster and more accurate changes in premiums in response to these changes, both of which the steering group views as positive outcomes of the use of competing private delivery.

### Cost increases resulting from Government action

535 The costs of private delivery may be artificially increased by the actions of government. Some of the most important potential cost increases will come:

- if the potential economies of scope available to private insurance are restricted by government policy on the bundling of different types of cover or policies that supplement the minimum required cover
- in the form of negative public commentary as private delivery changes the culture from the current public view of the ACC Scheme as part of the welfare net and entitlement to accident compensation insurance.

### Conclusion

536 In the transition from public monopoly to competitive private provision the path of prices is uncertain. The regulatory environment and the nature of the transition could have a material impact on the prices set. The extent to which the levies of the public monopoly insurer were set at fully-funded levels, regulations imposed on the competitive market and the nature of the transition process could all have a material influence on prices. On the basis of the evidence that we have obtained, it is unlikely that the average premium set by competing private insurers will be higher than the fully-funded levies of the ACC Scheme. However, if the levies of the Scheme are held below the fully-funded actuarially fair level, then prices may increase under private delivery, though this will represent an increase that was required in any event and should not be attributed to private delivery per se. It is also likely that there will be greater differentiation of premiums under private delivery, so it is possible that premiums for some risk pools will increase even though the premiums for other pools will decrease.

537 Ministers may limit the potential for concern about pricing in a competitive private market through the following actions:

- ensuring that the premiums set for the ACC Scheme before the introduction of competition are at the level that is consistent with actuarially fair prices calculated on the basis that private insurers are required to use
- eliminating known cross-subsidies in the Scheme, particularly for identifiable high-risk parties
- reducing uncertainty about the political commitment to private delivery. Any mechanisms that increase the credibility of the commitment of government to private delivery will encourage private insurers to adopt pricing strategies that spread their up-front costs of entry over the longest possible period, thus reducing premiums.
- minimising the regulatory constraints on private insurers introducing innovative approaches to the offer of insurance that provides the minimum cover, including restrictions on experience-rating and self-insurance.

## 13 Introducing competition

### Introduction

538 This chapter first considers the rationale for the introduction of competitive private delivery for the individual ACC Accounts. It then provides an outline of the conditions that would need to be met, the likely feasible timeframe, and the issues that would need further consideration, if competition were to be introduced. Finally, it considers the role of the ACC in a future competitive market.

### The case for competition in the delivery of the individual ACC Accounts

539 In line with our analysis in preceding sections of this report, the Steering Group believes that there is a clear rationale for the introduction of competitive private delivery in the Work Account. The risks in this Account are insurance risks, the premium is appropriately levied on employers, and accident prevention and rehabilitation will be promoted by private sector approaches to risk and experience rating of premiums. New Zealand's brief experience of introducing competition in the Work Account in 1999, together with the wide range of countries using competitive private delivery for workplace accident compensation, demonstrate the feasibility of this arrangement.

540 The Earners' Account has a natural fit with the Work Account. Although work-related injuries may affect what employers pay in premiums and thus affect their bottom line, the employer is not so concerned about the cause of the injury (work or leisure time) but the resultant time off work, productivity disruption, and cost of hiring and training replacement workers. The key issue is to get New Zealand workers back to sustainable productive lifestyles no matter what has caused their incapacity for work. These common elements in the insurance of workplace and non-workplace injuries to workers, and the adverse selection problems that would be associated with regulatory separation of the Work and Earners' Accounts, make it highly desirable to introduce competition simultaneously in both Accounts. Accordingly, the introduction of competitive private delivery of the Earners' Account simultaneously with the Work Account is recommended.

541 Currently all employees pay a set rate per \$100 of liable income no matter what their leisure time activities, age, or lifestyle, and the premium is collected via payroll deduction by employers, who then pay this to IRD. IRD then forwards this on to ACC. This creates potential cross-subsidies in favour of older earners (if they have more injuries that take longer to rehabilitate) and it is likely that under competitive private delivery the insurance industry would create a mechanism for reducing these cross-subsidies so long as this was administratively feasible.

542 While it is possible to imagine a wide range of options for choice on the part of earners, one practical solution would be to require as a default that earners use the same insurer

as the employer has chosen for the Work Account. There could, however, be the capability for the insurer to risk-rate the premiums deducted from the salary of each employee on the basis of information supplied relating age, leisure activities etc. Further, it would be desirable to allow earners to have the opportunity to bundle this insurance with other personal insurance products that they are purchasing, and to have their employer make payments on their behalf to an insurer other than the Work Account insurer of the employer.

- 543 The Motor Vehicle Account has a natural fit with the insurance against (first and third party) damage and theft of the vehicle purchased by most vehicle owners, and the current regulatory separation of these two categories of insurance appears costly and unnecessary. Some consideration would need to be given to the precise mechanisms by which compulsory purchase of personal injury motor vehicle insurance would be monitored, but this issue has arisen and been addressed successfully in other jurisdictions. At present there are substantial cross-subsidies across different risk pools in this Account, which would likely be removed by competition. We therefore consider that there is a clear and compelling rationale for private delivery of this insurance.
- 544 The Non-Earners' Account may not be capable of being delivered by competitive private insurers because the insured parties may not have the capacity to pay the premium. This Account thus provides the opportunity for substantial reform but of a different type. If other ACC Accounts were transferred to private delivery, the government could consider removing the Non-Earners' Account from the compulsory insurance framework, and instead integrating it with the general social welfare net.
- 545 The current funding arrangements for the Treatment Injury Account also make competitive private delivery difficult in its current form. At the moment this Account is funded by contributions from the Non-Earners' and Earners' Accounts. For this Account to be subject to private delivery it would need to be set up on a basis where medical practitioners, or medical practitioners and their employers, purchased this insurance as part of a broader suite of professional indemnity insurance.
- 546 The Steering Group therefore considers that three of the current ACC Accounts – Work, Earners', and Motor Vehicle - can be delivered by competing private delivery, and that the transition to private delivery could be achieved relatively quickly. If the government was to adopt this approach it would have the advantage of providing to insurers and to the public a credible commitment to reform accident compensation in New Zealand and to introduce a sustainable form of competitive private delivery.

## Conditions for efficient introduction of competitive private delivery

547 Our analysis of the transition from public monopoly to competitive private delivery in other insurance markets and submissions received from the insurance industry suggest that the following factors will be important in establishing competitive private delivery for compulsory accident compensation in New Zealand:

- a transparent set of regulatory requirements for entry to and continued operation in the market
- comprehensive and timely access to the data held by the ACC that may be used as a basis for initial underwriting positions, and reasonable ongoing access to market-wide data from the competitive private market
- reasonable certainty that the competitive market will be in place for a substantial period of time so long as it operates effectively. This is required because private insurers must make a substantial up-front (sunk) investment in entry to the market. The greater the certainty of the market continuing, the longer the time period over which insurers will plan to recover those costs, and thus the lower the market premiums will be.
- freedom to determine the most efficient and effective means of delivering the compulsory cover to the market. This will include the freedom to set premiums at levels that are actuarially fair for identifiable risk pools and for large employers. It will also include the ability to bundle the minimum cover into broader insurance products, including higher levels of cover for accidents and cover for loss of income or ill-health from non-accidental causes.
- an appropriate dispute resolution process that will provide both insurers and insured parties with confidence that any disputes will be resolved impartially and consistent with existing law and regulation
- an effective mechanism for dealing with the unfunded liabilities from operation of the Scheme under public monopoly delivery so that there is an assurance that the hangover of unfunded liability will not distort pricing in the market. A mechanism to deal with the funding and management of claims that pre-date the introduction of competition is also needed.

## Timing

548 If the recommendations of this Report are accepted then the government should immediately establish a group of officials and experts on ACC to work on aspects of the detailed implementation of the competitive private market as set out below. That work will take at least the remainder of 2010, perhaps longer.

549 2011 is an election year, and consultation with the insurance industry has made us aware that there are substantial concerns about any requirement to make substantial sunk investments in the new market before an election. Insurers have therefore indicated that the ideal date for competitive private delivery to begin would be six months following

election of a government committed to this policy, which suggests 1 April 2012 as an effective operational date for competitive private delivery of the Work and Earners' Accounts.

- 550 The insurance industry faces resource constraints on its ability to put in place the staff and systems, as well as the additional equity capital, necessary to acquire large new tranches of business. For this reason the industry has suggested that the introduction of private competitive delivery into the Motor Vehicle Account should occur from 1 April 2013. The steering group concurs with this recommendation.

## Creation of the framework for a competitive private market

- 551 If the recommendations of this Report are accepted, a wide variety of detailed work will need to be undertaken to determine structural and operational features of the competitive private accident insurance market. Below we provide an outline of the most important of these issues and some suggestions about how they may be addressed.
- i Specification of the minimum insurance cover required by statute in a form that minimises the transaction costs of integrating this into the broader insurance market.
  - ii Creation of a minimum set of requirements to be in contracts, and consideration of whether a broader range of regulatory interventions would be required to make competitive delivery feasible.
  - iii Creation of a claims management clearing house in which all insurers participate to minimise the costs of medical practitioners in submitting claims.
  - iv Creation of an effective compulsory mechanism in which all insurers participate to provide insurance to those parties who do not obtain insurance but nonetheless must be covered by the insurance market.
  - v Consideration of the extent to which premiums for high risk activities can be unregulated if purchase is mandatory.
  - vi Boundary issues associated with each Account will need to be addressed, and in addition there will be unique issues for each Account. For example, our recommendation that competitive private delivery be introduced simultaneously for the Work and Earners' Accounts will require that consideration be given to the treatment of individuals who are employed by more than one firm, the feasibility of giving earners a choice of insurer (different from the insurer chosen by the employer), and the scope of options to choose levels of coverage and self-insurance.
  - vii Is there a need for catastrophe protection from a single event such as a major earthquake? Insurers have represented that they are unable to buy unlimited reinsurance cover so may need to reinsure an element of the catastrophic risk with the Crown.
  - viii Is the prudential regulation regime being established by the Reserve Bank of New Zealand appropriate for the markets that would be created by competitive private

delivery of accident insurance, especially given that purchase of this insurance is compulsory? It may be that a fund to insure the solvency of each insurer, collected as a levy on all market participants, is required.

- ix Insurers see merit in having a single serious treatment unit. Such a unit requires specialist skills and replication might be inefficient even if the resources existed in New Zealand to establish multiple units. The issues to be addressed are i) whether the unit would underwrite the risk, with insurers ceding the premium for the risk (like reinsurance), or whether the unit would only provide a claims management service on a fee basis and ii) should a particular view of this be enshrined in statute or regulation or be left to the insurers to determine.
- x Treatment of and payment for health services. There will need to be efficient and transparent arrangements for the procurement of health services for accident sufferers, and any existing constraints on negotiations to this end between insurers and health service providers should be removed.
- xi The mechanism for the separation of funding and management of residual levies from the competition market.

This (non-exhaustive) list of matters to be addressed indicates the scope of the task ahead.

- 552 We have not assessed the merits of these choices. However, a general point is that the more the scope of competition is restricted, the smaller the benefits from introducing competition.
- 553 Executing the above tasks well will require a high level of administrative capability, legal and economic expertise, and detailed knowledge of the insurance industry, including its existing regulatory environment, the ACC, and its interface with the wider health system.
- 554 If the government wishes to introduce legislation this year or early next year there is a need for urgency in commencing work in these issues. The longer the delay, the greater the risk that decisions will be less well-informed than is desirable. Well-informed ministerial decisions about choices among different options as this work proceeds will help reduce the scope of the implementation group's work.
- 555 The Steering Group suggests that the Department of Labour in conjunction with Treasury should be asked to advise Ministers urgently on how best to set up an implementation group with access to the necessary range of skills and expertise.

## The role of ACC in a competitive private market

- 556 A key feature of any policy decisions about the creation of a competitive private market will be the consideration of what role, if any, ACC should have in the future.
- 557 Following the recommendations that we have made, the ACC will have a role in managing the Motor Vehicle Account until it is transferred to the competitive market, and potentially in managing the Non-Earners' and the Treatment Injury Accounts. In addition, there will

be a need to manage the ongoing claims and the unfunded liabilities arising from the operation of the Work, Earners' and Motor Vehicle Accounts up until the time competition is introduced. This is the area in which we see the clearest role for the ACC – as a specialised manager of the residual liabilities arising from the past operation of the Scheme. This specialisation would provide considerable advantages in terms of the government's ability to set clear performance targets for the ACC and to monitor that performance.

558 If the ACC is allowed to operate in the competitive market it would as a minimum need to be provided with equity capital on the same basis that is required of private insurers, and meet all other regulatory and reporting conditions imposed on the private sector. Taking as a guide the capitalisation ratios of private sector accident compensation insurers at equity and reserves equal to 25% of outstanding claims liabilities, then the equity capital required by the ACC to write all of the business that it currently writes in the Work, Earners', and Motor Vehicle Accounts would be \$2.7 billion made up as follows:

<b>Equity capital required by the ACC to write current business</b>	
<b>Account</b>	<b>Equity required</b>
Work	\$1,500 million
Earners'	\$1,200 million
Motor Vehicle	\$1,750 million

559 If this approach was taken we consider that there is substantial risk that the ACC would be unsuccessful, and that the government would be unable to earn an appropriate return on the equity that it invested in the ACC. The reason is that the current competitive advantages of the ACC lie in the systems that it has established for clear claims and payments. ACC is very likely to be required (under the Commerce Act) to make these systems available to the whole market. ACC has some important competitive disadvantages, including the inability to write other types of insurance. Over time, most customers are likely to gravitate to insurers who can write a broader range of policies than just compulsory accident compensation.

560 However the Steering Group does not consider that there is any necessary reason for allowing the ACC to operate in the competitive market. We think that the difficulties involved in ensuring that the Corporation operates on a level playing field with private providers are considerable. Consequently, we do not recommend that the ACC or any government-owned entity operates in the competitive market.

561 Another potential role involves appointing ACC as the residual insurer in the market (ie, the insurer of those who have not obtained insurance). This could happen either by explicit agreement or, if there are restrictions on the premiums that private insurers can charge, by default as ACC loses all but the highest risk or highest administration cost claimants. Again, we do not see any necessary reason for the ACC to undertake this

business. In other countries the function of residual insurer is undertaken by a private insurer based on a levy of all insurers participating in the market. This is our preferred approach.

**Recommendation:** that the ACC not compete in the market, but be focused on efficient management of the outstanding claims liabilities incurred up to the time when competition is introduced.

## 14 Conclusion to Part B

- 562 The Steering Group has reviewed a wide range of issues and evidence bearing on the merits and feasibility of introducing competitive private delivery of the ACC Work Account. Our approach has been to consider the merits of competitive private delivery in relation to the ACC Scheme more generally because it has become clear to us that questions about the feasibility of competitive private delivery of the Work Account may not easily be separated from examination of the feasibility of private delivery in relation to other Accounts.
- 563 We have concluded that there is no compelling rationale in insurance practice or arising from market failure for delivery of accident compensation insurance through a monopoly State-owned entity such as the ACC.
- 564 Because it is primarily a compulsory insurance programme, rather than a social welfare scheme, the ACC Scheme will benefit from the expertise and technology of the private sector in the delivery of accident compensation services. The retention by the government of the power to determine the scope of, and benefits provided by, the Scheme, and to enforce compulsion in the payment of levies, is sufficient to deal with the legitimate interests of the Crown in the ACC Scheme.
- 565 Delivery of compulsory accident compensation insurance by private insurers is entrenched in many jurisdictions around the world and operates within a wide variety of legislative and regulatory frameworks.
- 566 The absence of equity capital in the ACC Scheme does not provide the advantages that are sometimes claimed by supporters of the current system. The costs to the community of the residual risk borne by equity investors in private companies are also present in the Scheme, but in the absence of equity investment the risks are borne in a less transparent way by current levy payers, including many small firms that are not efficient bearers of this risk. If posted premiums were to rise in a before-and-after sense because of the need to price future contingencies including the cost of equity capital explicitly, the improved transparency and accountability would be a benefit from introducing competition. However, the margins required to provide insurers with a return on capital are modest compared to the improvements in the efficiency of premium setting, and the improvement in accident and rehabilitation rates that could be expected with private delivery. It is therefore likely that the introduction of competition will put significant downward pressure on actuarially-based premiums.
- 567 We consider that competitive private delivery of compulsory accident compensation insurance in New Zealand has the ability to address, and provide for improved outcomes on, the policy issues identified in section 1 of this report. In particular, competitive private delivery of compulsory insurance would be likely to:

- transfer the burden of risk-bearing for the mispricing of premiums in relation to future accidents from current levy payers and the Crown to shareholders of the private insurance companies
- remove the potential for unfunded liabilities to affect the Crown's financial performance directly, since private insurers' exposure will not be consolidated in the Crown's financial accounts, and indirectly by removing the Crown's role as the implicit guarantor of the liabilities generated by claims in the privately underwritten markets
- allow for greater transparency in the performance of the accident compensation system, including the setting of premiums that more fairly reflect the risk of the insured party
- allow competition between insurers and specialist service providers to focus the performance of the compulsory insurance system on investment in accident prevention and rehabilitation, in part through the creation of a wider range of options for the use of discounts for investment in accident prevention and experience rating to affect the premiums actually paid
- create, and ensure a clearer public understanding of, the distinction between insurance – that the Crown requires employers, members of the workforce or drivers of vehicles to buy for social purposes - and social welfare. The introduction of private competitive delivery of compulsory insurance into those Accounts where it is feasible to use this delivery mechanism would allow a clarification that the remaining Accounts may be more appropriately considered to be part of the social welfare net and thus allow their benefits and delivery of these to be reconsidered accordingly (including the potential to transfer these to a pay-as-you-go basis used for other components of social welfare).
- provide and promote greater transparency and community understanding of the true (actuarially fair) cost of providing accident compensation benefits. Changes in the claims experience of each line of compulsory insurance would be reflected more quickly and more transparently in the premiums charged.
- ensure that the demands of shareholders in the insurance companies, accounting standards, and market regulations preclude the adoption of partially-funded premium levels in response to any extension of benefits or deterioration in claims experience or rehabilitation rates. Arrangements that largely eliminate the risk of under-pricing will markedly reduce the risk that future generations of firms or levy payers will be required to fund part of the costs of claims resulting from accidents that occurred in the past.

568 We consider that it would be feasible and desirable for the insurance industry to take over the business of the Work and Earners' Accounts by 1 April 2012. . This is because the common elements in the insurance of workplace and non-workplace injuries to workers, and the adverse selection problems that would be associated with regulatory separation of the Work and Earners' Accounts, make it highly desirable to introduce competition

simultaneously in both accounts. Competition could be introduced into the Motor Vehicle Account approximately one year later.

- 569 There is a need for more detailed analysis of a wide range of issues relating to the creation of a market for the insurance currently provided by the ACC Scheme, including the way in which the compulsory insurance requirements will be specified, the regulatory and dispute resolution framework for the market, the approach to dealing with uninsured parties, very high or uninsurable risks, catastrophic risk to the market as a whole, and the role of ACC following the creation of this market.

## Part C: Conclusions

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570 The Steering Group has reviewed a wide range of issues and evidence, and received input from a range of interested parties and expert advisers, bearing on the performance of the ACC Scheme and the causes of the dramatic increase in the outstanding claims liabilities of the Scheme between 2004 and 2009. We have also undertaken a detailed assessment of both the costs and benefits of monopoly public provision, and the merits and feasibility of competitive private delivery, of the ACC Scheme. Our conclusions may be summarised as follows:

- i The current structure of the ACC Scheme is fatally flawed.
- ii The ACC Scheme is primarily a compulsory insurance programme.
- iii Improvements to the ACC scheme are possible, but while the current structure of the scheme is retained they are unlikely to be sustainable.
- iv Resolution of the fundamental flaws of the ACC Scheme will require the introduction of competitive private delivery.
- v Competitive private delivery of the ACC Scheme is feasible, and has merit as a means of improving financial sustainability and the quality of services provided to levy payers and claimants.
- vi The introduction of competitive private delivery can be achieved over a relatively short time frame.

571 We consider each of these conclusions in more detail below.

### The current structure of the ACC scheme is fatally flawed

572 In the absence of competition we do not possess good benchmarks to judge ACC's management of overall Scheme performance. However, it is clear that the performance of the Scheme has deteriorated significantly since 2004 on all important measures, and in particular on claims rates, claims costs, rehabilitation rates, and Scheme solvency.

573 From 2004-2009 the ACC management and Board allowed an unanticipated increase in outstanding claims liabilities of \$5.8 billion, almost all of which was within the power of ACC management and the Board to control. This dwarfs the losses incurred by any other New Zealand financial institution over the past three years and represents an unacceptable failure of governance, regulation and monitoring. But it would be incorrect to attribute unanticipated cost increases solely to a failure of management, governance and monitoring. Cost increases of this magnitude could only occur in the presence of the systemic weaknesses of the scheme that we have identified.

574 The ACC Scheme is systemically flawed because it combines the complexity of a large financial institution, the pervasive incentive problems faced by all forms of insurance, and the potential for inefficiency that arises from public ownership and monopoly provision.

The combination of low rates of co-insurance and an absence of effective risk and experience rating is also a major source of inefficiency in the Scheme.

- 575 The scope of the ACC, and its regulatory separation from the remainder of the insurance industry in New Zealand, is inefficient. The presence of a state monopoly scheme with coverage as broad as the ACC has distorted the pattern of insurance purchase for the New Zealand population as a whole, while denying private insurers the ability to offer consumers more efficient packages of insurance cover and to obtain the scope and scale economies that participation in the accident insurance market would provide.
- 576 Monopoly provision precludes the innovation in claims management and rehabilitation services that is a pre-requisite for financial sustainability in the ACC Scheme because the absence of choice in underwriting and service delivery reduces the pressure on the ACC Board and management and makes it difficult to establish meaningful performance benchmarks. Monopoly provision of accident compensation services also militates against the development and delivery of innovative programmes aimed at specific groups within the community. For example, monopoly provision has to date failed to produce an effective response to the low utilisation of the Scheme by, and the high serious injury rates of, Māori people.
- 577 The history of the ACC Scheme to date is one of recurring crises resulting from rapid and unaffordable expansion of the claims liabilities of the Scheme followed by periods of greater focus on claims management and rehabilitation. We have recommended improvements to the operation, management, and governance of the current ACC Scheme that will assist in improving its performance. But so long as the current structure of the Scheme is maintained there is no guarantee that these reforms will prove to be durable across different management and governance regimes, and through different governments. The Steering Group has therefore formed the view that only significant structural reform can ensure the sustainability of the ACC Scheme in the medium and long term.

## The ACC scheme is primarily a compulsory insurance programme

- 578 The ACC Scheme has social purposes but it is primarily a compulsory insurance scheme. The Steering Group has reached the view that the accident compensation provided under the ACC Work, Earners', and Motor Vehicle Accounts is properly regarded as insurance because:
- the insured parties can be identified, and a premium paid on behalf of that party
  - specific contingencies are insured against, and a specific schedule of benefits is payable in the event of the occurrence of those contingencies
  - the contingencies covered are more predictable in a large sample of the population as a whole than they are for any individual

- the frequency and value of claims on the accident compensation scheme are affected by the incentives established by the form and value of the compensation benefits provided.

- 579 Viewed from the perspective of social welfare programmes the ACC is distinctive. Social welfare schemes normally provide minimum levels of support regardless of past income, whereas the ACC Scheme provides income-related benefits based on the concept of recompense for losses incurred as a result of an injury. This means that the ACC is designed to address the opportunity cost of injury not the maintenance of minimum socially acceptable standards of living, and therefore the benefits provided by the Scheme are at much higher levels than social welfare programmes. In addition, social welfare schemes are normally funded from general taxation, reflecting the explicit cross-subsidies that are embodied in them, whereas the ACC is funded by levies associated with each individual Account.
- 580 Fully funded premiums to cover accidents that have not yet occurred are required to achieve efficient and sustainable outcomes in an insurance scheme even though pay-as-you-go funding is common for social welfare schemes. Fully-funded premiums are efficient in the sense that they provide for a clearer link between the accident experience today and the premiums that are being paid. Fully-funded premiums avoid the inefficiency of departures from actuarially fair pricing and ensure that government and levy payers must face up to the true cost of any changes to the scope or entitlements in the Scheme.
- 581 The investment strategy of the ACC has been successful to date. The Steering Group does not support any direct political intervention in the investment policy of the ACC, and in particular considers that any direction to invest in ways that supported government economic development strategies would have the potential to impair the financial stability of the Scheme.
- 582 The decision of the Board of the ACC to operate within general public sector accounting guidelines by adopting a 75 percent risk margin in the valuation of the liabilities should be endorsed. The presence of an implicit government guarantee or the ability to impose levies for past unfunded liability are relevant to the solvency of the ACC because they bear on the likelihood of having assets sufficient to meet the outstanding claims liability, but they are not relevant to the valuation and the variance of the outstanding claims liability, and it is the latter that the risk margin addresses.

### Improvements to the current Scheme are possible

- 583 The current structure of levies for the ACC Scheme incorporates inefficiently high levels of cross-subsidisation that are impacting on the financial performance and value for money provided by the Scheme. Addressing this problem will require that the practices that are widely used in the insurance industry to increase efficiency and value for money are adopted within the Scheme. In particular, the Steering Group recommends much wider

adoption of risk and experience rating across all ACC Accounts. Risk and experience rating are socially desirable in that they have the effect of focusing the attention of employers on improving safety and reducing accidents. There are a wide range of options to introduce risk and experience rating beyond the minimal levels that currently apply to the Scheme.

- 584 The Steering Group considers that the introduction of a minimum co-payment is worthy of more detailed examination, both as a reasonable approach to sharing the burden of the ACC and as a means of removing the current incentives to report that injuries result from accidents. Investigation of the merits of a comprehensive co-payment would also need to include consideration of whether there would be a need to create mechanisms to reimburse those on very low incomes for the co-payment, and the costs of doing so.
- 585 The Partnership Programme is an example of a programme that enhances efficiency in insurance markets and that ACC has adopted from the private insurance sector. However, its implementation by the ACC is flawed, in part because the ACC faces no competitive pressure to ensure that the Partnership Programme works at the optimal level to provide employers with incentives to invest in safer workplaces.
- 586 Governance, regulation and monitoring of the ACC can be made more effective. Clearer objectives for the ACC Board and management that are more tightly linked to the achievement of the performance targets incorporated into the actuarial valuation, and a focus on ensuring that persons appointed to the ACC Board have experience, expertise, and sufficient time to be directors of a large and complex insurance organisation will all be of assistance. Monitoring of the ACC by government departments must be more timely, and involve independent analysis of performance by staff with an understanding of financial institutions. Reconstituting the ACC as a State-Owned Enterprise with explicit equity capital and the power to set levies (subject to regulatory oversight) would improve the ability of Ministers to hold the Board and management accountable for the overall performance of the Scheme.
- 587 Improvement in service provision, especially the management of long-term claims, will have the greatest impact on value for money from the ACC. This will arise if the Corporation is required to focus its efforts much more strongly on early intervention and improving rehabilitation rates, and in particular, on raising return to work rates in the first three months following the injury. This should be seen as part of the full range of changes that we have recommended, all of which will assist in reducing the 'entitlement culture' currently associated with ACC and returning to a focus on rehabilitation and compensation of actual losses resulting from accidents.

## Resolution requires competition

- 588 The suggestions for improvement to the current Scheme summarised above may produce improvements in efficiency under the current framework of public monopoly delivery, but even if fully implemented they will still leave governance, regulation, and monitoring at

levels that are weak by private sector standards. The performance of boards is inevitably reduced by the lack of financial incentives for directors to improve the value of the firm. Regulation can at best produce only a weak approximation of the consumer benefits that come from competition. In addition, the incentives of civil servants to produce timely and insightful monitoring is inevitably less than the incentives that apply to shareholders and customers of competitive firms who have choices about where they invest or buy services.

589 The potential improvements to the existing ACC Scheme that we have suggested will do no more than approximate the benefits the competitive private delivery will provide. This is because the long-term stability of the Scheme requires:

- immunisation from political processes that may reduce scheme stability and inhibit the pursuit of improved value for money for levy payers
- consumer choice, so that levy payers can respond directly to poor service, inefficient pricing and a lack of innovation
- a wide range of specialist underwriters and service providers who are likely to provide better service in niche markets, including those serving particular ethnic and socio-economic groups in society
- the transparency that is associated with private providers, including explicit equity capital and reserves to provide a buffer against short-term variations in financial performance.

590 In the absence of competitive private delivery of the accident compensation scheme it is unlikely that these requirements for long-term stability can be met. Unless competitive private delivery is introduced, the Steering Group considers it highly likely that there will be further performance problems with the ACC Scheme in the future. In particular, the absence of competition makes it highly likely that inefficiency resulting from the cycle of unanticipated cost increases that create large unfunded liabilities for past claims, followed by substantial increases in levies or taxes to fund those costs from past accidents, will continue.

## Competition has merits

591 The Steering Group considers that competitive private delivery of compulsory accident compensation insurance in New Zealand has the ability to address, and provide for improved outcomes on, the policy issues identified in Section 1 of this report. In particular, competitive private delivery of compulsory insurance would be likely to:

- transfer the burden of risk-bearing for unforeseen contingencies and unfunded liabilities arising in the future from current levy payers and the Crown to shareholders of the private insurance companies.
- remove the potential for unfunded liabilities to impact on the Crown's financial performance both directly, by removing the requirement for consolidation of the privately delivered parts of the ACC Scheme to be consolidated in the Crown's

financial accounts, and indirectly by removing the requirement for a Crown guarantee of the liabilities generated by claims in the privately underwritten markets

- allow greater transparency in the performance of the accident compensation system, including the setting of premiums that more fairly reflect the risk of the insured party
- allow competition between insurers and specialist service providers to focus the performance of the compulsory insurance system on investment in accident prevention and rehabilitation, in part through the creation of a wider range of options for the use of discounts for investment in accident prevention and experience rating to impact on the premiums actually paid
- create, and ensure a clearer public understanding of the distinction between insurance, that for social purposes the Crown requires employers, members of the workforce or drivers of automobiles to buy, and social welfare. The introduction of private competitive delivery of compulsory insurance into those Accounts where it is feasible to use this delivery mechanism would allow a clarification that the remaining Accounts may be more appropriately considered to be part of the social welfare net and thus allow their benefits and delivery of these to be reconsidered accordingly (including the potential to transfer these to a pay-as-you-go basis used for other components of social welfare).
- provide and promote greater transparency in community understanding of the true (actuarially fair) cost of providing accident compensation benefits. Changes in the claims experience of each line of compulsory insurance would be reflected more quickly and more transparently in the premiums charged.
- ensure that the disciplines provided by shareholders in the insurance companies, accounting standards, and market regulations precluding the adoption of partially-funded premium levels in response to any extension of benefits or deterioration in claims experience or rehabilitation rates, are available to remove the risk that future generations levy payers will be required to fund part of the costs of claims resulting from accidents that occurred in the past.

592 While Māori support retention of the current compulsory no-fault accident compensation system, many Māori are interested in and supportive of the introduction of competitive delivery of the ACC Scheme, which they characterise as a shift from provider choice (under a monopoly delivery model) to consumer choice (under a competitive delivery model). However there are some important caveats. A major driver of Māori interest in ‘choice’ or competition is the assumption that any new system will at least facilitate, and ideally encourage, a greater role for Māori providers as well as a greater appreciation of Māori values and tikanga. Support for competition is contingent upon Māori organisations being significant players in offering these potential choices.

## Competition is feasible

- 593 The right to sue is not necessary for efficient delivery of insurance by competing private providers. Indeed all of the socially important features of the ACC Scheme - compulsory cover, removal of the right to sue, and statutory determination of minimum benefit levels - can be preserved with the introduction of competing private delivery.
- 594 Delivery of compulsory accident compensation insurance by private insurers is entrenched in many jurisdictions around the world and operates within a wide variety of legislative and regulatory frameworks. In competitive private delivery compulsory insurance systems, extensive use of experience-rating and self-insurance forms a key component of the competitive process, as it does in a limited way within the context of the ACC Partnership Programme.
- 595 Experience rating and self insurance limit the potential for inefficient cross-subsidies, provide a check on the premiums set by insurers, and provide employers with clearer incentives to invest in accident prevention and effective rehabilitation. Provision for self insurance, with appropriate requirements for stop-loss cover, should be an important part of the introduction of competitive private delivery, including potentially for self-employed high net-worth individuals.

## The introduction of competition

- 596 Regulatory separation of insurance provision for different types of accidents is inefficient because it increases the transaction costs of levy payers in obtaining insurance cover and increases the scope for claims to be transferred between different parts of the insurance system. The benefits of competition will therefore be greater the wider is the range of accidents within which competition is allowed.
- 597 We consider that it would be feasible and desirable for the insurance industry to take over the business of the Work and Earners' Accounts by 1 April 2012. This is because the common elements in the insurance of workplace and non-workplace injuries to workers, and the adverse selection problems that would be associated with regulatory separation of the Work and Earners' Accounts, make it highly desirable to introduce competition simultaneously in both Accounts. Competition could be introduced into the Motor Vehicle Account approximately one year later.
- 598 The Steering Group does not consider that there is any necessary reason to allow the ACC to operate in the competitive markets. We think that the difficulties involved in ensuring that the Corporation operates on a level playing field with private providers are considerable. This view also applies to the role of residual insurer in the market (ie, the insurer of those who have not obtained insurance) since in other countries the function of residual insurer is undertaken by a private insurer based on a levy of all insurers participating in the market rather than a public entity. However, the ACC will have an

ongoing role in the management of the outstanding claims made up to the time when competition is introduced, and the scale of this business alone is substantial.

599 There is a need for more detailed analysis of a wide range of issues relating to the creation of a market for the insurance currently provided by the ACC, including the way in which the compulsory insurance requirements will be specified, the regulatory and dispute resolution framework for the market, the approach to dealing with uninsured parties, very high or uninsurable risks, catastrophic risk to the market as a whole, and the role of the ACC following the creation of this market. The Steering Group suggests that the Department of Labour in conjunction with Treasury should be asked to urgently advise Ministers on how best to set up an implementation group with access to the necessary range of skills and expertise.

**Recommendations:** Commission more detailed analysis of options for the implementation of competition including:

- i whether to introduce competition for employees' non-work injuries (the Earners' Account) and personal injuries arising from use of motor vehicles (the Motor Vehicle Account) so that the problems created by regulatory boundaries between insurance for different types of accidents can be removed and private insurers can better serve levy payers with a full range of accident insurance services
- ii options for design of the market and the associated institutions, including the form of the statutory requirement for cover, the allowable extent of experience rating and self-insurance, and provision for residual insurance cover in the market.

# Appendices

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## Appendix 1: Examples of competing private delivery of compulsory accident insurance in other jurisdictions

### An international survey

No other country in the world has an accident compensation system that is as comprehensive in its benefits and its application across all forms of accidents as that in New Zealand. In particular, in most countries individuals wanting comprehensive insurance cover for the effects of injuries sustained outside the workplace would purchase that cover from competing private insurers, or accept the much lower level of benefits provided by the social welfare and public health systems. Even in Holland, where there is no distinction between workplace and non-workplace injuries and all injuries are treated as part of the general social security system, a mixture of public and private provision is used. Thus, New Zealand's use of state monopoly provision to provide its citizens with insurance against the loss of income and the disability resulting from all forms of accidents is unique in both its scope and its impact on the scale and operation of the private insurance market.

If we confine our attention to international approaches to workplace accident compensation only, almost all schemes involve compulsory purchase of insurance and (in part as a consequence of compulsion) heavier regulation than is applied to other lines of insurance. Monopoly provision of the insurance through state-owned entities such as the ACC is utilised in many jurisdictions, but equally there are many jurisdictions in which competitive private delivery is used.

In the United States, laws relating to workplace accident compensation fall within the jurisdiction of the states, and there is great diversity in their arrangements. Only six states have monopoly state agencies providing workplace accident insurance and most use private insurers to deliver services, though eighteen states have a state-owned insurance provider competing with the private sector insurers. The US accident compensation markets are also notable for the high levels of self-insurance by large employers, groups of smaller employers and individuals (Munich Re 2000 p.20).

The predominant model for workers' compensation schemes in Canada is to use provincial monopoly providers, but in both Canada and the US compulsory personal injury and third party automobile insurance is most commonly provided by competing private insurers.

In Western Europe competing private insurers deliver some or all of the compulsory accident compensation insurance required in Norway, Denmark, Finland, Switzerland, Portugal and Belgium, while in the UK accident compensation insurance is not compulsory but employers are required to take out employers' liability insurance from private companies. However, France,

Germany, Italy, and Spain all have monopoly state provision of workplace accident compensation.

Both workplace accident insurance and personal injury motor accident insurance are compulsory in the states of Australia. Delivery regimes are more or less evenly divided between three different approaches: full public monopoly, public monopoly underwriting with claims management outsourced to third party administrators, and full competitive private delivery of underwriting and claims management.

In a range of other countries with compulsory workplace accident schemes, including Argentina, Singapore, Hong Kong and South Africa, competing private insurers provide all or part of the insurance mandated by the state.

We provide below more detailed outlines of competitive private delivery in four countries chosen to illustrate a range of different approaches to the organisation of the accident insurance market.

## Australia

Queensland and the Federal Government (Comcare) have comprehensive monopoly providers of underwriting and claims management for insurance against workplace accidents, but the compulsory personal injury motor vehicle insurance scheme in Queensland utilises competing private underwriting and service delivery. Three states, New South Wales, Victoria and South Australia, operate with public monopoly underwriting of the liabilities arising from insurance of workplace accidents, but depart from the model used for the ACC Scheme by outsourcing claims management to private third party administrators. In addition, the personal injury motor scheme in New South Wales utilises private underwriting and service delivery. In Western Australia, Tasmania, the Northern Territory, the ACT and the Seacare scheme, competitive private delivery of underwriting and claims management is used.

In addition, all Australian schemes allow self-insurance for large employers which can create significant competition in some public monopoly schemes (40% of coverage in the public monopoly scheme in South Australia is through self-insuring employers) and all Australian schemes provide for substantial experience rating to incentivise employer investment in accident and injury prevention.

The steering group commissioned an analysis of the nature of competition in those Australian workers' compensation schemes utilising private competitive underwriting and claims management, and has been informed that these markets have the following features:

- There is strong competition on premium and service levels, with employers shopping around for the best deal available. This competition results in customer churn for insurers that is often around 25% of policies written.
- Experience rating is widely used as a basis for linking the premium paid to the actual insurance risk, and is offered to employers with relatively small premium payments

(\$30,000 per annum and above). The more important is the component of experience rating in the premium set, the more important are the claims management and workplace accident safety services provided in the employers' choice of insurer.

- Services provided to employers by insurers include:
  - claims, injury and rehabilitation management, providing quality services to the employer and the claimant
  - reports on claims experience, and explanation of trends in claims experience, including “read” access to insurers’ IT systems to monitor claims progress
  - assistance in risk management and occupational health and safety, including advice on the choice and management of specialist third party providers of occupational health and safety services.
- Competition for the business of small employers is focused primarily on the basic premium level, given that there is limited scope for (statistical validity in) experience rating for these employers. Competition for the business of large employers focuses on the services provided (as set out above) since substantial use of experience rating provides opportunities for large cost savings if accident experience and claims management are improved.
- At least for large employers, the option to self-insure provides a further element of competition in the system as well as a continuum of options through various levels of experience rating to full self-insurance.

Competitive private delivery in Australia therefore appears to be effective in focusing competition on the creation of strong financial incentives to achieve the desirable social goal of improving safety records and improving rehabilitation and return to work outcomes. This appears to be the reason why, in its review of workers’ compensation published in 2004, the Australian Productivity Commission recommended both that the federal government promote employer self-insurance through the Comcare scheme, and that if the federal government established a national scheme to replace the individual state schemes, it should be underwritten by competing private insurers.

## Switzerland

Switzerland has had a compulsory accident insurance system in place since early in the 20th century, though it did not become comprehensive until 1984. Until that year statutory coverage extended only to factories and industries that were regarded as having relatively high risk of accidents, and the insurance was provided by a public monopoly insurance provider, the Swiss National Accident Insurance Fund (SUVA). When accident insurance cover was made compulsory for all employers in Switzerland in 1984, SUVA retained its existing monopoly over the provision of insurance to particular industries, but also a statutory prohibition on offering insurance outside the compulsory accident insurance cover. All other industries were opened up to private competition since many employers not required to take accident insurance from SUVA had none the less taken accident insurance from private sector companies.

At present accident insurance is provided by 38 general or health insurers in addition to SUVA. The scheme covers accidents, near-accident bodily harm, and occupational diseases. It covers medical benefits, rehabilitation costs, and income support at the rate of 80% of the pre-accident income. The introduction of private insurers has, however, focussed attention on the inefficiency that arises from the requirement that employers insuring with SUVA take only the statutory level of cover while employers insuring with private companies can obtain, or their employers can obtain, a variety of supplementary insurance cover on favourable terms. As a result there is currently a debate in Switzerland about the sustainability of the monopoly provided to SUVA, with deregulation and the privatisation of SUVA suggested as potential solutions.

## Finland

Finland has a total population of five million, and a statutory accident insurance system covering work accidents and occupational diseases that dates back to 1895. Self-employed individuals are not required to take out insurance, although they may elect to opt in to the scheme.

In Finland, the statutory accident insurance system is operated by 13 private insurance companies and two state funds – the Farmers' Social Insurance Institution (responsible for farmers) and the State Treasury Office (responsible for government employees). The operations of insurance companies are considered a part of public administration where they involve the implementation of statutory insurance (including statutory accident insurance and employment pension insurance). For this reason the private insurers in Finland are subject to a complex regulatory framework that involves the Ministry of Social Affairs and Health, the Federation of Insurance Institutions (a private body recognised in statute as the vehicle through which insurers engage with government and other stakeholders), and the Parliamentary Ombudsman.

Both the level of insurance and the benefits offered for workplace accident insurance in Finland are established by statute. The level of compensation is relatively high, often resulting in 100% compensation of all costs caused by the accident or occupational disease and the loss of earnings working capacity in the first year and in subsequent years an employment accident pension of 85% of previous annual earnings (70% after the age of 65). The accident insurers also provide advisory services for accident prevention and safety improvement. An insurance institution cannot reject an application for an insurance policy and an employer who has failed to take out insurance is covered by the Federation of Accident Insurance Institutions which levies the employer concerned for the additional insurance premium ex post.

Premium calculation for workers' compensation insurance was deregulated from 1 January 2000 as part of the implementation of certain EU directives, but the general principles in premium assessment are defined by the Employment Accident Insurance Act. However, according to Munich Re (2000), liberalisation of the rating calculation did result in a fall in the market premium as the result of increasing competition between private providers.

The framework for the calculation of the insurance premiums paid by employers continues to be tightly regulated by the Ministry of Social Affairs and Health. Small companies are generally set a rate based on a risk premium, administrative (including claims handling) costs and so-called statutory increments, and there is no provision for experience rating or discounting for investments in accident prevention. For large companies competition is more vigorous, with regulations allowing a full range of options from experience rating and discounts for investment in accident prevention, through to self-insurance with only stop-loss cover being purchased by the employer.

## Belgium

Belgium has a semi-privatised workers' compensation whose history dates back to the passage of legislation in 1903 providing lump sum payments to employees who had an accident, based on the no-fault principle. Currently Belgian workplace insurance is no-fault, but there are some exceptions for litigation where an employer deliberately causes an accident. Work accidents and accidents sustained on the way to and from work are compensated through the statutory accident insurance system.

Every employer is required to contract for insurance against accidents at work with a competent insurer, but self-employed individuals are not subject to mandatory coverage and the scheme does not cover occupational diseases. The Belgian Fund for Accidents at Work (FAO – FAT) supervises the insurance institutions and has oversight of the operation of the market. The FAO – FAT also acts as a residual insurer for those who do not get insurance, though unlike the private companies its insurance function is organised on a pay-as-you-go basis.

A victim of an accident at work is entitled to the reimbursement of the costs for hospital care, physiotherapy, medical, surgical, dental and pharmaceutical care as well as orthopaedic equipment. During the period of work incapacity, the claimant is entitled to 90% of the average day salary, subject to a cap of €36,809.73 per annum. For short-term claimants who are only partially incapacitated, compensation covers the difference between the salary earned before the accident and that earned after returning to work part-time. Long-term claims are subject to various tests of work capacity, and compensation is adjusted based on whether the claimant has any capacity to work.

Private insurance companies operating in this market must be licensed by the Ministry of Social Affairs. The Ministry supervises underwriting principles as well as the solvency of the different insurance companies and the overall market. The Ministry also oversees a complex regulatory framework relating to the tariffs set in the market.

Each licensed insurance company is obliged to calculate its own gross tariff based on the net tariff recommended by the Belgian Insurers' Association. The gross premiums for Belgian workers' compensation insurance vary between 0.5% and 10% of salary for salaried employees and between 1% and 10% of wages for wage earners. There are additional levies to cover commuting accidents and the costs of the market regulator. Insurers use experience rating for

individual firms to adjust the premiums charged, and to provide an incentive for investment in preventative measures and health protection. They are required to base the rating for large firms entirely on the claims experience of that firm. The private insurers also operate a pool for employers who cannot obtain cover within the de facto premium ceiling of 10% of salary and wages, paying the costs of this pool in proportion to their market share and with one of the private companies acting as administrator.

## Conclusion

Internationally, there is no normal or consensus approach to the extent of competition employed in the delivery of workplace accident compensation insurance. There are many examples of both public monopoly and competitive private delivery of compulsory workplace accident insurance, though New Zealand is unique in its use of public monopoly provision of insurance for all forms of accidents, and unusual for its limited use of risk and experience rating.

In a wide range of different countries there are examples of competitive private delivery models for compulsory workplace accident insurance that are effective and have exhibited stability over time. Competitive private delivery regimes range from those where regulation of the markets and the rates charged by the private insurers is limited, to those such as Belgium, that impose a complex regulatory framework on the operation of the workers' compensation insurance market, and Finland and Switzerland, where publicly owned insurers are allocated particular market niches or compete with the private sector.

Across the full range of schemes from public monopoly to lightly regulated competitive private delivery regimes competition is promoted by regulations that facilitate substantial use of experience rating up to and including full self-insurance for large firms.

For compulsory personal injury and third party motor vehicle insurance, competitive private delivery is overwhelmingly the most common delivery model used in other countries.

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## Appendix 3

### Members of the Steering Group

Hon David Caygill, Chairman

John Judge, Chairman of the ACC Board

Allan Morris (from 20 November 2009)

Neil Quigley (until 28 February 2010)

Gordon Smith

Hemi Toia (from 20 November 2009)

Bryce Wilkinson (from 20 November 2009)

With support from officials from the Department of Labour, The Treasury, and the Department of the Prime Minister and Cabinet

## Appendix 4

### Terms of reference for the Stocktake of ACC Accounts

#### Purpose

These terms of reference outline the scope of the Stocktake of ACC Accounts (the Stocktake) project.

The overall purpose of the Stocktake is to provide an assessment of the performance of each of the ACC accounts, an analysis of how the Scheme could be improved to deliver value for money to levy payers and taxpayers, and identification of potential financial savings.

#### Background

The Stocktake is the government's top priority for the ACC portfolio because it will provide the information on which to base future decisions that improve the efficiency and affordability of the ACC Scheme.

#### Scope

The Stocktake steering group will commission work to achieve a series of succinct reports that inform the government. This work is likely to include:

**A: analysis of each active Account,** covering:

- its underlying cost drivers (these are likely to vary for each Account) and strategies to address them
- how many people come into the Account, how long they receive entitlements under the Account; the entitlements they get, how the interpretation of legislation impact when providing those entitlements; how and whether injury prevention works in the Account
- any subsidisation occurring within the Account or across other Accounts
- options for funding policy (eg, change in balance of funding sources, such as funding the Motor Vehicle Account from petrol as opposed to licences etc)
- the nature of major risks (eg, underwriting, investment performance, liability valuation risks) – who bears these risks and options for managing them
- the constraints on achieving value for money and a steady-state financial position (for example administrative factors or legislation)
- the potential for, and cost effectiveness of, introducing experience rating or risk-sharing.

Note that background information will be made available to the steering group from ACC on financial forecasts for each Account covering 2008/09 and subsequent financial years, and trends in funding (levies and appropriations) if no change is made to policy settings. ACC will also make available to the steering group its own analysis and Account funding plans, and information on claims duration and case management practice.

**B: monitoring of ACC's performance:** including the performance of the monitoring agency and the usefulness of existing performance indicators. The results from the government-wide review of monitoring of Crown agencies being led by the Treasury will be made available to the Stocktake steering group once Ministers have considered the proposals. The Stocktake will also consider the performance information available, whether the existing performance indicators will provide the information needed for

robust monitoring, and proposals for different or better performance indicators as appropriate

**C: assessment of:**

- current employer programmes, and incentives to encourage more businesses to focus on health and safety in return for levy discounts
- how injuries sustained outside the workplace by workers can be efficiently managed and paid for by employers to promote rehabilitation
- who is best placed to provide effective rehabilitation services.

**D: a review of ACC's \$10 billion investment portfolio,** to examine its contribution to the goals of scheme sustainability and levy stability. The ACC Board's review report will be made available to the steering group. The steering group will also comment, and as necessary make recommendations, on how the reserves are being managed (in a quality of processes sense) and the appropriateness of the current level and form of scrutiny of this function from the ACC Board.

**E: analysis of key changes in legislation** over time and their impact on claimant entitlements.

**F: investigation of the introduction of competition and choice into the Work Account.** This investigation needs to consider the merits and feasibility for New Zealand of opening the Work Account to competition, and outline a process to achieve this policy objective in a way that resolves any significant outstanding issues. This work will also include an exploration of other areas in which the private and non-government sectors (including iwi) can be involved in injury management and compensation.

In addition, the steering group is able to raise with the Minister additional areas of work it considers are necessary.

## Process

The project is expected to commence in August 2009 and will be completed by the end of June 2010.

One or more independent consultant(s) will be appointed by the steering group through a procurement process according to State sector guidelines.

The steering group will ensure that there is opportunity for key stakeholders such as Business NZ and the Council of Trade Unions to have input at appropriate junctures of the Stocktake process, such as following receipt of the initial reports from external consultants and before formal advice is provided to the Minister for ACC.

## Timing and deliverables

It is expected that the project will begin in August 2009.

An interim report outlining progress with the investigation of choice and competition in the Work Account will be provided to the Minister for ACC by 1 February 2010 and the final report with recommendations for the Scheme as a whole will be delivered by the end of June 2010.

## Governance

The Minister for ACC will be the sponsor for the project.

## Steering group

A steering group with an independent Chair, and comprising additional independent advisors supported by senior officials, will provide oversight of the project, commission the work, monitor progress, and assess and report the results.

The steering group will ensure that the advice provided meets the stated objectives of the project.

The steering group will determine its own schedule and programme. Members will be expected to meet as directed by the Chair during the course of the project. Work will also be undertaken using, as necessary, teleconferencing and email contact.

## Consultants

The steering group will ensure that the consultants appointed:

- have the requisite skill sets and competence to undertake the work commissioned
- will be mindful of the considerable public interest this project will generate, and will conduct the work in such a way as to be sensitive to this interest
- have no conflicts of interest that may influence the independence of the advice being provided
- are able to deliver the work within the set timeframes.

## Assumptions

Background material and data will be made available to the consultant(s) as needed.

Key people within ACC and the Department of Labour will be made available to the consultant(s) as appropriate and necessary, for interviews or as part of a group consultative process. Meetings with key people in central agencies may also be required.

## Budget

The overall budget will be overseen by the steering group.

The budget for undertaking specific pieces of work and for individual parts of the project will be agreed with the consultant(s) through the initial procurement process and on confirmation of the approach.

Payments will be phased according to delivery of the main pieces of work and meeting of time and quality performance measures as agreed between the parties.

## Communications

The Stocktake steering group will ensure relevant parties are kept informed about progress with the Stocktake as necessary and as the Chair deems appropriate.