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Senate Finance and Public Administration Committee
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Dear Mr Sands

At the public hearing of the Committee in relation to the Medicare Private Sale Bill 2006, the Australian Medical Association (AMA) undertook to provide a supplementary submission to address issues raised by members of the Committee.

The AMA also seeks to clarify some issues addressed in our primary submission.

Restatement of the AMA's position

I must emphasise at the outset that the AMA does not have a philosophical objection to Government's selling assets when appropriate. That is not the basis of our concerns in relation to the proposed sale.

In the hearing, Dr Choong-Siew Yong observed that Australia has been very well served by a health system that involves elements of both public and private sector service delivery. Australians have access to a large number of high quality health services.

To say that we are doing well is not to say that we cannot do better. Health professionals constantly strive for improvements in health outcomes, quality and safety. At this point, the interests of providers and patients (and the long term interests of government also) coincide.

The public and private health sectors play complementary roles. The AMA believes that there is a long term future for both. The AMA is a strong and unabashed supporter of the Government's strategy of financial support for members of private health insurance funds. While the policy may not have bipartisan political support, it is good public policy and it has very widespread community support.

The AMA's concerns in relation to the sale of Medibank Private are that the sale will result in higher premiums for members of private health funds. In the first instance, the higher premiums will have an impact on the members of Medibank Private. However, Medibank Private is a major player in every State/Territory health insurance market. Higher premiums will make Medibank Private less competitive and will allow other funds to raise their premiums also.

In the view of the AMA, these outcomes are deleterious to the broad strategy of support for private health insurance. The sale of Medibank Private will inevitably have a deleterious

impact on the Budget cost of maintaining that support. The Parliament needs to consider all budgetary impacts of the sale, not just the expected sale proceeds.

Why does the AMA expect Medibank Private's premiums to rise?

The AMA expects Medibank Private premiums to rise due to the burden of servicing the equity if the organisation is sold and the limited scope for efficiency gains. It is not relevant that Medibank Private is now generating an operating surplus. That operating surplus is required to self-fund the capital that is required, including both capital expenditure and the maintenance of financial reserves as required by the prudential rules under which all private health insurance funds operate. It cannot be diverted without consequences. To service the equity in the event of a sale, the operating surplus will have to be substantially higher than it is now.

The cost of servicing equity is ultimately a matter for the market to decide and will reflect the sale price, the financing metric and the market's expectations as to an appropriate risk-rated return.

The AMA has observed that there is market speculation that the sale price could be of the order of \$1 billion to \$2 billion. This could imply an annual cost of servicing equity of \$150 million to \$300 million per annum, the smaller of these two amounts being in excess of the 2004-05 operating surplus of \$130 million.

In 2004-05, Medibank Private's margins were slightly below the industry average (a gross margin¹ of 11.6% compared with the industry average of 12.2% and a net margin² of 2.4% compared with the industry average of 2.7%). Historically, Medibank Private has achieved a gross margin of the order of 9.3% to 9.4% on average, while the net margin has been negative on average (that is to say, Medibank Private has depended upon other revenue, primarily income on investments, to achieve an operating surplus).

Based on 2004-05 data, if all costs of servicing equity have to be met by higher premiums, Medibank Private's gross margin would have to rise from 11.6% to between 16.4% and 20.7%, the net margin would have to rise from 2.4% to between 7.7% and 12.5%, and thus the sale would push premiums higher by between 5.8% and 11.5%.

The scope of efficiency gains

The AMA is of the view that there is some scope for minor savings in management expenses across the industry as well as within Medibank Private. As the largest private health fund, Medibank Private has achieved a management expense ratio on most years which is a little below the average. We doubt that Medibank Private has fully exploited the scope for scale efficiencies. Were they to manage as efficiently as BUPA (the most efficient of the large funds), they could save some \$30 million per annum in management expenses.

The report by CRA International (CRAI) argues that Medibank Private could achieve efficiency gains of 5 to 7%. Based on 2004-05 figures, that would imply cutting costs (management expenses and benefits paid) by between \$127 and \$178 million per annum.

¹ The Private Health Insurance Administration Council (PHIAC) defines the **gross margin** as contributions income less benefits paid and less State levies as a percentage of contributions income.

² PHIAC defines the **net margin** as contributions income less benefits paid less State levies and less management expenses as a percentage of contributions income.

It is simply not possible to cut nearly \$180 million out of management expenses of \$238 million. Such cuts in costs would necessarily require cuts in benefits paid. Cuts in benefits paid reduce the quality of the private health insurance product. It follows that they also reduce the price such a product can command in the market.

Consumers can and do discriminate between health insurance products on quality grounds. People with private health insurance value the choice of doctor and hospital. They expect to have some say in who, what, when and where.

The CRAI report cites MBF as a more efficient fund than Medibank Private on the grounds that MBF pays lower benefits. MBF offers less choice than Medibank Private, for example, it does not offer any known-gap insurance products. Over the last dozen years or so, Medibank Private has gained market share across Australia while MBF has lost market share. Consumers are expressing their preferences as to the value for money offered by each.

The AMA completely rejects the findings of the CRAI report as to the scope for efficiency gains. It is completely meaningless to compare raw premiums data without taking account of the differences in the quality of the product. CRAI has chosen to ignore the revenue implications of a lesser quality product. The impact on net revenues could well be negative. That is to say, the impact of reducing the quality of the policies may be to reduce contributions income by more than the reduction in benefits paid. In addition, management expenses are frequently "sticky" and the loss of scale economies associated with the loss of market share may well mean a higher management expense ratio, not a lower one.

In summary, there is no doubt in our minds that there is scope for Medibank Private to achieve some minor efficiency gains. These cannot generate nearly enough to service the equity in the event of a sale. The reaping of these efficiency gains is not, in any case, dependent upon a sale. There is very little scope for Medibank Private to reduce benefits paid without impairing revenue.

The cost of servicing equity

As noted above, the cost of servicing equity in the event of a sale is a matter that will be determined in and by the market. There is, nonetheless, some responsibility on policy makers to assess the likely cost of servicing the equity in the event of a sale.

The CRAI report speculates that "*Approximately 1 percentage point of this efficiency gain would be required post-privatisation to allow Medibank Private to earn a pre-tax market rate of return on assets*". This seems to us to be a clear statement that the current operating surplus is not sufficient post-privatisation. The 1 percentage point figure is, as we understand it, equivalent to \$25.4 million in that year based on 2004-05 costs of \$2,536 million (comprising \$2,298 million in benefits paid and \$238 million in management costs).

If Medibank Private were sold for \$1 billion, this may imply that CRAI envisage a return on investment of 2.54%, while if it were sold for \$2 billion, the return halves to 1.27%. In short, it seems to imply a Price Earnings (PE) ratio of 40 to 80.

In this respect, we find the CRAI conclusions to be completely implausible.

Commonwealth Government control over PHI premiums

In the hearings, it was put to AMA representatives that premiums would not blow out in the event of a sale of Medibank Private because they are subject to regulation by the Federal Health Minister. The stark evidence is that Federal Government regulation of private health insurance premiums does not keep premiums down but simply makes them more volatile. When the power has been used to deny appropriate premium increases (for example, in the lead-up to a Federal election), the effect of the price freeze has simply been to plunge the funds into operating deficits. This places the Federal Government in an impossible position because the regulation of prices, when misused in that nature, cannot be reconciled with the prudential requirements with which all funds must comply. In following years, much larger increases have to be approved to allow the funds to recover their reserves. The Minister cannot seriously contemplate triggering bankruptcies.

Price regulation of this nature does not work. If the Federal Government is seriously interested in keeping premiums down, the solution is obvious. Reduce the barriers to new entry and take steps to encourage more vibrant competition between the funds. The current steps to reduce the regulation of the funds would seem to our minds to be one essential step if the barriers to new entry are to come down.

Application of sale proceeds

In the hearings, AMA representatives were asked to consider a scenario in which the sale proceeds were hypothecated to public health.

In response to this we note that Australia has a long history of cost and blame shifting between the Federal and State/territory governments. This is not limited to health and it is not improving. We have observed many occasions where a Federal Government health initiative has been stymied by State and Territory Government trucking the new money out the back door and appropriating it to other purposes.

In short, we do not see how any Federal Government could surmount this difficulty to make the new money "stick" in public health.

Furthermore, the central policy departments are well known to be implacably opposed to any hypothecation of revenue and, by and large, they have been successful in opposing such arrangements.

If Medibank Private is sold, then it is obvious that the AMA would strongly prefer the proceeds to be spent on health care. However, the scenario itself is assessed as undeliverable. It would be a very great irony were the proceeds from the sale of Medibank Private ultimately squandered by State Governments on their own bureaucracies and pork-barrelling projects.

Yours sincerely



Dr E. Robyn Mason

Secretary General

17 November 2006