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Independent Review of the Relationship Between Physiotherapists and ACC

In Support of Submission of
New Zealand Society of Physiotherapists

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Executive Summary

1. KPMG Corporate Finance has been commissioned by the New Zealand Society of Physiotherapists (“NZSP”) to provide analysis of and commentary on the Deloitte Physiotherapy Pricing Project (the “Deloitte Process”). Our brief initially covered the Deloitte Process itself, but was extended to incorporate work on this Independent Review.
2. NZSP’s brief to KPMG has required that we take a pragmatic approach, if possible, and direct our analysis towards any necessary changes to the structure and inputs of the Deloitte model. If able to be achieved, this approach has the benefits of allowing debate to focus on specific model issues, and differences of opinion regarding appropriate data inputs.
3. Our analysis of the model at the centre of the Deloitte process has been hampered by the fact that we have had limited access to it, and the model has essentially remained a black box. We are therefore not in a position to express any final views, as we need to have more understanding and confidence in the robustness of the underlying model.
4. Checks on the outputs of the Deloitte model run by NZSP do however indicate some concern as to the robustness of the model and methodology. It appears that use of assumed consult times as an integral part of estimating a sustainable hourly price creates high risks of error, due to the variability of that data source, and the likely use of different time estimates in prior setting of EPN consult prices. We believe that this can be worked around by a method such as assessing the percentage cost uplift required to achieve sustainability, and then applying that or a similar percentage uplift to existing prices.
5. Deloitte’s approach includes adjustment of historical salary data, as they assume that those surveyed salaries are not at sustainable levels. We agree with that analysis, which is unsurprising given the potential for market distortion cause by ACC policy and varying levels of subsidy. We consider that real debate is required about the level of adjustment required to that and other figures to achieve sustainability.
6. KPMG has also identified a range of other cost data and methodological approaches which we consider should be altered to better reflect the sustainable costs of the profession, which is the basis upon which the model assess price. Those issues are detailed in the body of this submission.



Introduction and Qualifications

7. My name is Troy Newton. I am a Director of KPMG Corporate Finance New Zealand, and leader of the Wellington arm of that business.
8. I am a Chartered Accountant, a member of the Institute of Chartered Accountants of New Zealand and obtained a Bachelor of Commerce and Administration degree from Victoria University of Wellington. I have had or hold various governance level appointments including as a Director of Crown Owned companies, having served as the Deputy Chair of Industrial Research Limited and Audit Committee Chair for the National Institute of Water and Atmospheric Research Limited.
9. KPMG was approached by New Zealand Society of Physiotherapists (“NZSP”) to assist with their input into the Deloitte Physiotherapy pricing project (the “Deloitte Process”) in late 2005. We met with the NZSP and their legal advisor, Martin Taylor Barrister in early 2005 and provided advice in relation to that project. I understand that the Deloitte project has been outlined in the NZSP submission, and the Reviewer is familiar with the outline of that project.
10. Following NZSP’s lack of satisfaction with the outcome of the Deloitte Process, we have also been asked to assist by providing a submission to this Independent Review, outlining our view of the appropriate manner in which to identify sustainable fees.

KPMG’s Instructions in the Review

11. Our instructions from NZSP are to consider the sustainable long run costs and pricing of all physiotherapy services. We are aware of and have read in draft the brief of Brent Wheeler Limited (“BWL”). Our approach builds on a number of principles or positions identified in that report. However, we consider that we are charged with addressing detailed current pricing issues. BWL considers some of the points of principle raised in our submission, and otherwise deals with higher level issues of principle, rather than the financial detail we consider.
12. NZSP’s main submission has identified its view that the economic assessment undertaken in the Deloitte Process is essentially identical to the assessment to be undertaken in this Review.¹ We agree with NZSP that these Terms of Reference are focused around the long term or sustainable pricing of physiotherapy services, as we set out below.
13. NZSP also wish to gain a practical outcome from this Review. As the Deloitte Project and NZSP’s responses to that material cover the same ground as this Review, it provides an extremely useful existing dialogue on price assessment. We have therefore agreed to fit our commentary and solutions to the economic issues raised within the framework of the Deloitte Project costing and pricing model (the “Deloitte model”).

¹ They acknowledge that this Review may also consider regulation and other payment arrangements, rather than solely EPN payments.



14. The Deloitte Project is effectively an activity-based costing exercise. This is simply an exercise where a business' activities are identified and costed, and then attributed on a reasonably detailed basis to the products or revenue streams of that business. This is intended to provide a best estimate of the actual cost of a product or revenue stream.
15. We are able to present our view of sustainable physiotherapy pricing in terms of alternative data inputs and assumptions which we consider should be entered into the existing Deloitte model.² The benefit of this approach for the Reviewer is that it provides a common analytical base. The focus is then properly on the merits of competing assumptions and data, rather than on distinguishing between different methodological approaches.

Sources of Evidence

16. The evidence used in this submission is primarily sourced either from Deloitte's surveyed data or from advice or data supplied by NZSP. Except where data is directly sourced by KPMG (e.g. return on investment data), KPMG has accepted the data from NZSP or other relevant source, and relies on that source as to the data's accuracy.

Representativeness of Data

17. The practice survey data from the Deloitte Project is not a statistically reliable sample of New Zealand practices, either in terms of the manner in which they were chosen, or the breadth of the sample size. In spite of this, there is an implicit assumption that the data collected is generally representative enough of the population of New Zealand physiotherapists to provide a rough estimate of:
 - 17.1. The costs facing a typical practice (as adjusted for sustainability);
 - 17.2. The number of ACC funded consults for a typical practice;
 - 17.3. The proportion of additional revenue from sources other than EPN and Regulation consults; and therefore
 - 17.4. The price per hour and per consult which must be paid by ACC to cover costs, and provide an appropriate return on investment to a business owner.
18. In practice, it would most likely be difficult to secure the type of data which was sought by Deloitte across a statistically significant sample group. We have accepted this data as our working basis, subject to specific changes noted by NZSP.

² Please note that KPMG may have taken a different modelling or assessment approach had we been commissioned to undertake such a pricing project from scratch. In spite of this we are able to work with the Deloitte model.



Assessment Framework

Long Run Approach Required

19. The terms of reference (Issue 1.1) essentially focus on the level of payments necessary to retain:

... an appropriately sized skilled and financially viable physiotherapy profession to meet the needs of ACC claimants.

20. We consider that this requires a long run approach to the pricing of services contracts. We consider that this is also encapsulated within the label “sustainable pricing”, and that sustainability is focused on safeguarding long term outcomes.
21. This implies pricing of these services not be at the lowest possible level as this will probably result in financial distress and business failure, but at a level which will maintain the capacity of the profession to provide services in an appropriate quantity and to an appropriate quality. As BWL has stated, underinvestment leads to risk in relation to the delivery of an appropriate quality and quantity of services to ACC consumers.
22. A long term pricing approach is also appropriate given the dominant position of ACC is the physiotherapy purchasing market. The Deloitte Project revealed that approximately 80% of revenue from the sample practices was generated from visits either partially or fully funded by ACC. NZSP considers that this understates the general position, but even at the level identified in the sample practices, ACC is a dominant purchaser.
23. This high level of revenue from ACC means that pricing decisions by ACC will heavily affect business outcomes for physiotherapists, to such an extent that the size, skill and viability of the profession is effectively dictated by the financial parameters set by ACC. The more that providers switch to the EPN scheme, where surcharging is prohibited, the more absolute this link will become.
24. One may also assume that the lead in times for adjustments to size, skill and viability of the profession are relatively long.³ This reinforces the view that a long-run pricing approach, together with a suitable uncertainty premium in such pricing for avoiding under or disinvestment risk by providers, is appropriate, as the effects of underinvestment will require a significant period for correction to occur, during which patient outcomes will be compromised.
25. This fits with the standard approach which we would take if applying an activity-based costing approach to a business, particularly where regulatory price constraints were involved. A pricing approach needs to incorporate long term sustainability if economic efficiency is to be achieved in tandem with long term returns, such as those sought by ACC.

³ Due to the 4 year training period for new physiotherapists, the Continuing professional development requirements which make re-entry to the profession difficult after extended absence, the significant investment in capital assets and certification systems which is required, and other such factors.

Importance of Labour Costs

26. We note NZSP's view that a sustainable profession is one which in the physiotherapy context requires a high quality of personnel, training, facilities, equipment, systems and techniques. The Deloitte Final Draft Report indicates that 72.8% of a practice's expenses are labour costs. This is unsurprising in a professional services business, but places emphasis on labour as a key issue in terms of financial and economic assessment.

Historic Costs Not Necessarily Sustainable or Appropriate

27. There is no certainty that the historic costs of a business are a sound basis for gauging what is sustainable or appropriate for the long term viability of the business. In any given situation those costs may be squeezed by a business which has inadequate revenue and has therefore had to trim costs to the detriment of the businesses long term viability. Alternatively there may be fat in the system due to poor business processes or operation of the business at other than maximum efficiency.
28. We agree with BWL that there is likely to have been distortion of the total historic price (subsidy plus surcharge) charged by physiotherapy providers prior to introduction of the EPN scheme. The following points reported by NZSP give us real concern as to the sustainability of those prices, particularly in regard to business owner remuneration, staff salaries, and ability to reinvest in businesses. NZSP report:
- 28.1. strong and vocal public resistance to paying any significant physiotherapy surcharges – we agree that willingness to pay can be affected by external pressures such as perceptions of ACC policy;
 - 28.2. physiotherapy being a course of treatment, with an average of 6 – 7 visits⁴ - we agree that the cumulative effect of a reasonably small per visit co-payment becomes significant for some patients and their ability to pay over a course of treatment of this length;
 - 28.3. increasing surcharges has decreased demand – this is a natural market outcome, but at odds with ACC's policy;
 - 28.4. physiotherapists have sought to fulfil ACC's policy of full public access by maintaining surcharges below appropriate economic levels - we consider that evidence showing stagnation of salaries and return to owners, or decreases when measured against CPI, is likely to indicate market distortion; and
 - 28.5. staff shortages and practice closures – a pattern of such shortages and closures may be indicative of poor sustainability.

⁴ Telephone conversation between Catherine Hall, ACC, and Gail Leach, NZSP, dated 15 August 2006.



29. Ultimately Deloitte’s surveyed data indicated that physiotherapist / business were receiving salaries on average of:⁵

Metropolitan	\$48,000
Urban	\$42,000
Rural	\$38,000

30. These figures are extremely low pay rates for the owner of a professional services firm. From an economic perspective they do not represent a return commensurate with a business owner’s training, working hours and effort.
31. To identify total return to the business owner one would add the return on investment which is also calculated within the model. Such a return will depend on the level of investment made by the owner, alternative investment opportunities available to them with the same resources and financing decisions.⁶ Even after adding the ROI component proposed by Deloitte analysis we still consider that this is an extremely low aggregate level of earnings given the amount of effort and financial investment made by the owner in the business.
32. Accordingly we would not consider a physiotherapy business to be a good investment or economic prospect. It may be a factor in the notable lack of aggregation in the sector. This alone leads us to believe that, as they currently stand, physiotherapy businesses are not, and the profession generally is not, operating at a sustainable level.

Use of Compco / Benchmark Data

33. A standard approach in business costing, particularly pre-start up, is to use comparable process, comparable market (together “compco”) or benchmark data as part of an activity based costing exercise. This approach has merit as it allows comparison or analysis based on functional lines, or a different business in a comparable market, going beyond any anomalies or peculiarities of the subject business. It is an appropriate method to assess future sustainable cost where current costs may not be sustainable.

⁵ Refer Deloitte Hybrid Model March 06 spreadsheet, “Changes Made to Model” tab.

⁶ This data is supported by the New Zealand Business Benchmarking Survey 2005 (Physiotherapy), Bundle Tab X. That shows median net profit per working owner as \$63,250 (which includes salary and return on investment), and median salary per FTE as \$33,042.



34. Taking into account the sustainability focus of this review, we consider that:
 - 34.1. There are a number of cost streams and pricing factors which can be adopted from the historic data arising from Deloitte's survey; but
 - 34.2. Upon examination a number of other cost streams and pricing factors are more appropriately sourced from benchmark data.
35. Even if there is disagreement between the parties as to which historic data should be used and where benchmark data should be used instead, the compco approach is useful in any case. That is, comparison to benchmark data is itself a useful indicator of the appropriateness of the historic data. For example, consideration of benchmark data for the cost of setting up an average clinic itself reveals a large gap between the historic asset data used by Deloitte. Provided we accept that the benchmark data is valid, then this gap indicates that there is currently underinvestment in business assets.
36. This particular effect should be addressed by incorporating depreciation costs on the assets of a new average clinic, rather than the historic data. It is only in this way that the costs and prices calculated in this modelling process will reflect and be able to fund ongoing development and maintenance of clinics which meet the standards of a modern, certified physiotherapy practice.
37. In this instance, the size of the Deloitte survey sample is not statistically significant, meaning that the results are not technically robust. We consider that this is a further reason why, if there is concern as to the representativeness or sustainability of a particular data point from the survey, reference to compco or benchmark data is appropriate.

Deloitte Approach Consistent with Compco / Benchmark Use

38. NZSP has received a copy of a report by Deloitte written for the IPA Council of New Zealand (January 2002), entitled **Sustainable Costing of General Practice Medical and Accident Services** ("IPAC Report"). At page 24 of that report Deloitte stated:

... current difficulties relating to GP recruitment and retention suggest that the "sustainable" remuneration level is above the current actual remuneration level achieved by many GPs.



39. The report highlighted the importance of labour costs to sustainability:

Both individually and collectively, GP remuneration will need to be at levels that:

- *Meet the expectations of individual GPs*
- *Enable a sustainable GP “workforce” to be acquired and retained.*

40. This is prior recognition by Deloitte that historic costs of a business, and in particular labour costs, may not always be sustainable, and may need adjustment to achieve sustainability.
41. Further, the report produced by the Deloitte Process (the “Deloitte Report”) itself accepts a benchmarking approach and use of non-historic costs in respect of business owner salaries. The salary figures used are not historic costs, but are instead equivalents to a perceived DHB benchmark, which are then adjusted to account for a business owner’s “time not captured in the financials”.⁷
42. Any arguments which suggest that only historic costs are relevant, or that price should be set solely by indexing the total price previously received by physiotherapists in the open market (i.e. regulation subsidy plus copayment), can therefore be dismissed. The need for adjustment of historic data is acknowledged in the Deloitte Report. The question before the reviewer is one of scale and degree as to which data should be adjusted, and to what extent?

Preliminary Issue - Effect of Prohibition on Co-Payments Under EPN

43. We agree with BWL that the EPN contract represents price control, subject only to limited ability to charge patients for materials, after hours consultations and limited other matters. We also agree that price control is unlikely to contribute to the goal of sustainability for the physiotherapy profession. This is because:
- 43.1. where businesses are on EPN contracts, this is likely to account for approximately 80% of their revenue;
- 43.2. this means that these physiotherapists are heavily reliant on the revenue from these EPN consults;
- 43.3. any error in the pricing of these consults will, where there is no ability to seek a top-up from the client to achieve sustainable pricing, severely affect the performance of the practice;

⁷ Refer Deloitte Draft Report, December 2006, page 19.



- 43.4. it is in any case impossible to account for all price related contingencies, or to implement a flexible price across the provider group which will treat all members of the group fairly according to their individual circumstances; and
- 43.5. if there is price control, then unless the ACC price paid is set at the **top** of the range of correctly estimated practitioner costs, there will always be a significant number of practitioners whose costs are justifiably and unavoidably greater than the rest of the profession, and who will therefore become unsustainable and unable to provide quality physiotherapy services to the community.
- 44. From a simple economic point of view, it is inappropriate to regulate the fees able to be charged by private businesses, except in very special circumstances such as monopoly providers who may otherwise exploit the market.
- 45. We are not aware of any evidence, from the market or from ACC, of providers exploiting the market when surcharging was allowed. In fact:
 - 45.1. We agree with BWL that it appears likely that ACC's public access policy, combined with lack of movement in regulation rates over time, resulted in significant downwards distortion of the total price being charged by physiotherapists.
 - 45.2. The original surveyed data indicated business owner physiotherapists taking home \$38,000 to \$48,000 per annum plus a return on their investment. This is in our experience extremely low remuneration for owners of professional service businesses. It does not show any evidence of profiteering.

EPN Should be Costed at High Percentile if Prohibition Remains

- 46. In spite of our view as to its merits, the current EPN regime prohibits co-payments. If this policy is to continue, then it is a significant factor of which account needs to be taken in price setting.
- 47. We understand, from NZSP's involvement (consultation only) in the initial setting up of the EPN contract, that EPN rates were derived from an initial survey of practice prices in September 2003. Consultation prices were assessed by taking Regulation payments (\$19 incl GST), plus co-payments, to derive total consult price.
- 48. We further understand that the EPN rate was set at the 87th percentile of actual practice prices identified by that survey. We understand that this was adopted in order to reflect the fact that co-payments are prohibited under EPN. The setting of the EPN payments at a high percentile therefore seeks to ensure that the majority of practices are able to operate on a sustainable basis.

49. This can be seen as a “margin of error” or safety zone, which ensures overall sustainability in the profession. It means that the least possible number of businesses have their sustainability compromised in the maintaining of a zero patient fee.
50. We believe that, if the prohibition on copayment is to be continued, then in the interests of business sustainability, pricing at a high percentile such as the 87th is appropriate. We note that Deloitte reports average prices, which are likely to be close to the median or 50th percentile, though they do report pricing at higher percentiles as a sensitivity analysis. We consider that use of a higher percentile should be adopted.
51. As noted, this approach was used in originally setting up the EPN by taking the 87th percentile of total price. We consider that it is equally appropriate for use on this cost-based modelling approach. There is no significant difference between the two approaches.

Practical Costing at Higher Percentile

52. In practical terms, we consider that this should be achieved by the model process as it is currently envisaged, including the “backing out” of actual costs and insertion of sustainable costs where appropriate. This should be undertaken on an individual practice basis. The individual practices should then be ranked, and the practice cost / price at the 87th percentile should be identified as the appropriate EPN price point.
53. There is some difficulty in backing out particular data, such as salaries, and then inserting data at the 87th percentile. Each practice is made up of a collection of costs, and each cost is likely to occur at a different point in the overall range for that cost. The inclusion of all sustainable costs at the 87th percentile would therefore create a “super practice” with high costs in each cost bracket, rather than actually estimating the costs of a practice at a realistic 87th percentile.
54. To accommodate this, we believe that all adjusted costs, other than labour, should simply be incorporated as an average cost. However, labour comprises 78% of current costs.⁸ It must therefore be adjusted towards the 87th percentile of salary costs due to its materiality on final pricing. In order to be conservative however, we consider that the inclusion of adjusted salary data at the 75th percentile is a feasible alternative. Once salaries are entered for all practices at the 75th percentile level, and other appropriate adjustments made, the practices should then be ranked, and the practice at the 87th percentile taken as the appropriate EPN price point, as discussed above.

⁸ Refer to “Hybrid Model” excel workbook as supplied to NZSP’s advisors. We consider that, when truly sustainable business owner and clinical salaries are incorporated, labour may in fact comprise a much greater percentage of total cost.



Analysis and Response to Deloitte Model / Draft Report

Introductory Comments

55. KPMG is broadly comfortable with the basic structure of the Deloitte model, which derives the price per hour of consults by the formula [attributable cost plus margin] / [consult hours]. Again, in line with NZSP's desire to achieve practical outcomes, the model may be acceptable as a basis for cost estimation within the New Zealand physiotherapy sector, though we do not believe it does at present.
56. However, extreme care is needed in use of the model, and such use must take into account factors such as:
- 56.1. **The safety margin required in controlled prices.** The EPN was established at the 87th percentile of regulation subsidy plus copayments in 2004 to provide a safety margin for the sustainability of businesses that were no longer able to surcharge to recover any costs whatsoever. Use of average historic cost data from 2004 / 2005 will not replicate this "safety margin" and must be avoided because:
- 56.1.1. the "safety margin" effectively takes the form of an increased profit margin that may not show up reliably in cost figures;
- 56.1.2. if it was to appear in cost figures this would probably be by application to salaries, and there are likely to be timing differences between when they were first received by the businesses and when they show up, on an annualised basis, as salaries; and
- 56.1.3. 52% of the EPN / regulation visits (adjusted) used as the cost base by Deloitte were undertaken by regulation practices,⁹ and did not therefore contain this safety margin.
- 56.2. **Sensitivity to Estimated Consult Times.** The model also appears extremely sensitive to the effects of estimated consult times, both as between the various EPN consult types, and as between EPN and regulation consults. The fact that 49% of the unadjusted consults were undertaken by regulation practices means that the time estimates for those consults must be just as precise as (and consistent with) EPN consult time estimates.
- 56.3. **Weightings / Adjustments Used in the Model.** There are weightings or adjustments used in a number of places within the model, notably in modifying actual consult numbers.¹⁰ This must be fully explained and examined for logic prior to acceptance of the model validity.

⁹ Refer Deloitte Hybrid Model March 06 spreadsheet, "Total" tab, consult volumes unadjusted.

¹⁰ Refer Deloitte Hybrid Model March 06 spreadsheet, "Total" tab. Consult volumes [weighted] are expressed to be 64,362, and 62,237, without adequate explanation of how the 62,237 figure is derived, and why it is used as the divisor for the [total cost / consult hours].



57. Because of the potential for these matters to distort the outcomes, we need to ensure that appropriate cross-checks are performed on the final proposed outcomes to see that they achieve in practice what the model claims they do.
58. Ultimately therefore, there need to be common sense checks run on final prices derived from the Deloitte model. In particular we consider that the final hourly rate proposed by Deloitte should be applied to the total EPN consult numbers used in the Deloitte model to derive a revenue figure. This should then be compared to the surveyed EPN revenue figure, updated by the Labour Cost Index (“LCI”) to match the 2006/07 base at which Deloitte expresses its recommended prices.
59. In comparison the revenue figure using Deloitte’s modelled hourly price should be significantly higher than the surveyed EPN revenue figure adjusted by LCI. This increase reflects the fact that Deloitte attempt to increase salaries and add other economic increases in their modelled hourly price. If this result is not achieved, then prima facie, this challenges confidence levels in the model.

Manner in Which Hourly Rate is Expressed

60. The Deloitte Report expresses the outcomes of their modelling as a price per hour which they recommend ought to be paid to physiotherapists. It must be noted that this is however the price per hour of face to face consult time. There are other patient related activities such as communication with case managers, writing up case notes and so on which NZSP advises are undertaken in addition to face to face time.
61. The actual price paid per hour to physiotherapists across all billable activity (i.e. all direct patient-related work) will therefore be significantly lower than the hourly rate reported by Deloitte. This could reduce the hourly rate reported by 10 – 30%, according to the proportion of patient-related time which is not spent face to face.

Consult Time

Weighting of Regulation Consults

62. NZSP advises that they consider that the times estimated for an EPN initial and follow up visit, as incorporated at Deloitte Final Draft Report p 18, are not unreasonable for the purposes conceptual analysis. Further work, of course, would be required for something as crucial as setting final prices. However, the Regulation times as recorded by ACC are differentiated only by initial and follow-up consult, and do not separate out complex and simple consultations.



63. It appears that the times / weightings for Regulation consults (both initial and follow-up) within the model are an average of the simple and complex times / weightings within the initial and follow-up categories of EPN. However, there is a much lower level of complex visits than simple visits. This means that the basic averages of simple and complex time allowances taken for initial and follow up regulation visits are likely to overstate the time spent in regulation consults. This in turn will produce an understated cost per hour, as costs will be diluted across an incorrectly high number of consult hours.
64. NZSP advise that they consider that provision of services under regulation payment takes exactly the same amounts of time as for visits paid for under an EPN contract. They further believe that the balance between simple and complex patients for Regulation providers is the same as that for EPN providers.
65. On this basis, we consider that the best method of identifying composite times for a generic regulation initial and regulation follow-up visit is by application of the ratio of simple / complex EPN visits to the total number of regulation visits.
66. For EPN consultations the percentage of simple initial (and follow-up) visits (as a percentage of total EPN initial visits) and that of complex initial (and follow-up) visits can be derived from the survey data.¹¹ From this information, a simple-weighted average initial (and follow-up) consult weight can be calculated which reflects the likely ratio of simple to complex Regulation consults.¹² As a formula:

Regulation (initial) weight =

$$\text{PT01 consults/total initial consults} \times \text{PT01 weight} + (\text{total PT03 consults/total initial consults} \times \text{PT03 weight})$$

Regulation (follow-up) weight =

$$(\text{PT02 consults/total initial consults} \times \text{PT02 weight}) + (\text{total PT04 consults/total initial consults} \times \text{PT04 weight})$$

¹¹ Refer to Hybrid Model workbook, total sheet, "ACC consults – volume [unadjusted]". We have used this data set for our calculation of appropriate Regulation consult weightings.

¹² Please note that we will be seeking an amendment to Regulation fees to ensure it reflects the different time required for simple and complex cases in the future.



67. The results of the above analysis are shown in the following table.

	Average time	Weights	Number of consults	Percentage	Weighted average	Time (min)
EPN - PT01 (simple initial)	30 mins	0.500	12,475	93.8%		
EPN - PT03 (complex initial)	40 mins	0.667	819	6.2%		
Total EPN initial			13,294		0.510	30.616
EPN - PT02 (simple follow up)	20 mins	0.333	61,453	92%		
EPN - PT04 (complex follow up)	30 mins	0.500	5,184	8%		
Total EPN follow-up			66,637		0.346	20.778

68. Through this process, we derive the following consult weights for Regulation visits, in comparison to those currently included within the model.

	Regulation Initial	Regulation Follow-Up
NZSP Consultation weights	.510	.346
Current Deloitte Weighting	.583	.417



69. We believe that the impact of the differences between the NZSP calculated weights and Deloitte's assumed weights will be significant. We believe that the model should be amended to reflect NZSP consultation weights for Regulation visits as described above. This has important distributive implications between the EPN and the Regulation consult prices.

Issues with the Methodology / Assumptions

70. We have identified a number of issues with the methodology and assumptions contained in the Deloitte Final Draft Report. The primary issues identified are:
 - 70.1. the weighting of costs equally between EPN / Regulation revenue and other revenue does not reflect the foundational nature of that EPN / Regulation revenue as opposed to private and other revenue, nor the fact that the majority of practice fixed costs are unavoidable incidents of that EPN / Regulation revenue;
 - 70.2. the report previously included, in my view, an inadequate percentage for return on investment. We understand that this has now been upgraded to 15% ROI, which is still at the lower end of our recommended range, but which we consider to be adequate for the purposes of the model;
 - 70.3. we do not believe that the current treatment of fixed assets, which is based on depreciated cost, provides a sustainable estimate of the reinvestment required in fixed assets going forward;
 - 70.4. there is an inadequate capturing of goodwill, potentially other intangibles, and working capital investment, upon which a return on investment is also due;
 - 70.5. the predominant use of data at an average cost point rather than higher percentiles does not assist in identifying sustainable prices for EPN contracts (due to the current prohibition on co-payments) – see commentary in paragraph 56 above; and
 - 70.6. we do not believe that the report adequately captures the sustainable salaries which are necessary to drive the profession forward in a manner which ensures the retention of the skilled and experienced physiotherapy workforce required to meet the rehabilitation needs of the New Zealand public.



Allocation of costs (weightings)

71. The approach taken by Deloitte currently allocates cost across all service lines/offerings on the basis of the proportion of total revenue derived from these sources by the physiotherapy practices surveyed. That is, the percentage of total cost assigned to EPN/Regulation activities is the percentage that EPN/Regulation revenue forms as an average proportion of total revenue.
72. NZSP has two issues with this. The first is the use of the average figure, given the statistical properties of the data set. The second is the more fundamental concern that this approach does not recognise the true importance of ACC revenue to the operational and financial functioning of physiotherapy practices.

Use of the Median More Appropriate

73. The data set for the revenue splits between EPN / Regulation and other forms of revenue contains the following:
 - 73.1. one practice with only 29.5% EPN / Regulation revenue, offset by a high proportion of ABP revenue;
 - 73.2. four more practices with 50% or less EPN / Regulation revenue.
74. As noted above, NZSP does not consider that the average revenue split derived (67%) is representative. They consider that it would be extremely rare for practices to have 50% or less of EPN / Regulation revenue, and consider that these practices within the data set have inappropriately affected the average.
75. We note that the median revenue split is in fact 71.6% EPN / Regulation revenue. In the circumstances, we believe that this is a more appropriate figure to use as the basis of the revenue split. This ameliorates, but does not overcome, the effects of the outliers within the data set, without the need to subjectively adjust other data. In particular we consider that it is still appropriate to use this median revenue split whilst continuing to use other data from the survey set, such as total numbers of consults provided in order to earn this revenue split.

An alternative approach would be to exclude the outliers from this data set when identifying the average revenue split.



Use of Unavoidable Cost Principles More Appropriate

76. The current methodology does not recognise the crucial underwriting effect of EPN and Regulation revenues to the non discretionary and non variable costs of most physiotherapy practices. In light of the aims of the project, to provide a sustainable estimate of the price to be paid for physiotherapy services, it is appropriate to allocate costs using a methodology that recognises the economic under-writing effect of certain revenues.
77. The model should provide a weighting of costs which reflects the fact that certain fixed and semi-fixed costs that are mostly or wholly attributable to the provision of EPN and Regulation services. The costs would be those required to maintain the consulting hours, capability and capacity necessary to service the EPN / Regulation market alone.
78. One such methodology is the Avoidable Cost Allocation Methodology (“ACAM”). ACAM is an economically robust methodology and has been used in New Zealand by regulators to determine a ‘fair’ revenue for gas pipeline businesses. A substantial body of work has been undertaken in this area by the Ministry of Economic Development.
79. The basic tenets of ACAM involve firstly defining the core business as the ‘stand-alone’ business and making an assessment of the expenses, revenues, assets and liabilities that would be avoided by the core business owner if it did not operate its other (‘incremental’) business. The components of the items that cannot be avoided are allocated to the core business, and the components that would be avoided are allocated to the other business.
80. We consider that revenues from EPN and Regulation sources are the ‘foundation’ or ‘core’ income for funding the fixed and semi-fixed costs of operating a sustainable physiotherapy business offering patient access at the sorts of times and in locations they require and expect. That is, without this revenue it would not be economic to continue to operate, as it would be unsustainable to operate an hour-by-hour, fully variable-costed, private-consult only practice. In contrast pilates, retail, private consults, and other revenue is incremental revenue which, while of supplemental value, is not key to sustaining a physiotherapy business, especially not the typical physiotherapy practice.
81. In addition, while Deloitte cites the average proportion of EPN and Regulation revenues (67%), we have already noted that:
 - 81.1. the average was affected by providers within the survey who had large amounts of non-EPN/Regulation revenue. Many practices surveyed had a much greater proportion of EPN / Regulation revenues than that indicated by the average; and
 - 81.2. NZSP considers that the majority of practices nationally would have at least 80% EPN / Regulation revenue.



82. If 80% of revenue is derived from EPN / Regulation, this reinforces the case for this to be treated as foundation revenue.
83. We therefore provide below the percentage of total costs which we believe are “unavoidable” costs, which would need to be incurred to earn EPN / Regulation revenue even if that was the sole practice income. These weighting are based on the 80% EPN / Regulation revenue split which we believe to be appropriate. Note also that we have separated costs into the five costing pools as determined by Deloitte.

Cost pool	% allocation of total costs to EPN/Regulation services
Labour	90% – 100% ^a
Equipment	~100%
Consumables	90% – 100% ^b
Facility (Premises)	~100% ^c
Overheads	~100%

^a labour is largely fixed as long hours and peak capacity requirements would still be required to service the EPN & Regulation market.

^b consumables use relates largely to the provision of acute (EPN & and Regulation) services.

^c facility costs are fixed, as current facility is necessary to service peak capacity requirements where/when EPN & Regulation services primarily provided.

84. In order to apply the weightings above, derived on our assumed 80% revenue split, to the model, we have undertaken the following process:
- 84.1. Identified the respective multipliers needed to convert the assumed 80% revenue split to the appropriate unavoidable cost split above (e.g. for equipment, the multiplier to move from the 80% split to 100% unavoidable cost split is $100 / 80 = 1.25$);
- 84.2. Substitute the median revenue based split (72% after rounding) for the mean average currently used; and
- 84.3. Apply these multipliers to the median 72% revenue-based EPN / Regulation split to derive the cost weightings to be applied to the respective cost pools within the Model.



85. This methodology is more appropriate because it adopts a weighting – expressed as a multiplier - based on what NZSP believes is a truly reflective EPN / Regulation revenue split. The use of multipliers allows unavoidable costs principles to be applied to the actual revenue split within the sample data, as set out in following table.

Cost pool	Mid-point % cost allocation to EPN/Regulation services	Multiplier	Cost weightings for Model
Labour	95%	1.19 (ie 95%/80%)	86% (ie 72% × 1.19)
Equipment	100%	1.25	90%
Consumables	95%	1.19	86%
Facility/Premises	100%	1.25	90%
Overheads	100%	1.25	90%

86. We consider that the cost weightings set out in the above table should therefore be used in the Deloitte model as a more appropriate basis for cost attribution.

Basis for determining value of fixed assets

Current Approach Does Not Model Sustainable Costs

87. The book values of assets (grossed up for depreciation incurred over the life of the assets) are used as the basis for the valuation of fixed assets within the model, without any allowance for inflationary factors. The use of asset book value or historic cost without consideration of the current asset replacement costs, let alone future operating capacity, is flawed. It does not represent a sustainable asset base from which to operate a physiotherapy practice.

88. We understand that no analysis was undertaken to benchmark book values against current requirements, replacement costs or economic values to assess sustainability. In addition, while more recent (and thus arguably more applicable) facility and set-up costs provided by NZSP were acknowledged by Deloitte, the information was not used, nor was further corroborating information sought, to assess the reasonableness of the non-current historical data provided by the surveyed practices.
89. We note that Deloitte made the following comment within the IPAC report:¹³
- the GP premises (i.e. the actual data supplied by GPs) may not reflect the “standard” required for a modern sustainable GP facility in the medium term.*
90. There is no evidence to suggest that similar consideration has been given to the premises (and hence fixed assets) required to operate a sustainable physiotherapy practice. Bearing in mind NZSP claims that the profession has been undercapitalised, one would expect this to be carefully considered. Similarly, no evidence is provided (as discussed above) as to what a sustainable fixed asset base for operating a physiotherapy practice in the future may be.

Use of ORC Methodology More Appropriate

91. We consider that a much more appropriate method of ascertaining the sustainable fixed asset base for operating a physiotherapy practice is optimised replacement cost (“ORC”). ORC is the current or present day cost of acquiring an asset but where the asset value is ‘optimised’ such that the asset provides an efficient quantity and level of service commensurate with expected market demand. This best fits with the project brief of assessing sustainable costs for physiotherapy practices.
92. An advantage in the use of ORC to identify sustainable prices, compared to using the historical cost of assets, is that ORC is more likely to replicate or mimic the pricing outcome that might be observed in an unconstrained, competitive market. This is because prices are based on the cost of an efficient level of assets to a new entrant or competitor that may wish to enter the business and receive a normal rate of return on their investment. For established providers, ORC better indicates the future lump sum costs of upgrading to competitive equipment.
93. The use of ORC therefore reflects forward looking costs (a key outcome of this project) rather than the potentially biased historic cost of providing the service. Similar to risks faced by asset owners in a highly competitive market, optimisation of the assets reflects the costs of demand shifts and asset obsolescence.

¹³ IPAC Report (2002)

94. We are also concerned that the model and approach taken by Deloitte does not take into account significant Information Technology (“IT”) systems capital expenditure required in the near future to bring physiotherapy practices up to a satisfactory standard. It is clear that the certification requirements being imposed on the profession will require extensive IT investment for many practices. NZSP also believes that practices will be required to invest in additional IT capability in the near future as part of the ongoing relationship and modern communication with ACC, other health providers, and other stakeholders in physiotherapy treatment.

Conclusion on Valuation of Fixed Assets

95. We conclude that the existing historic cost data within the Model does not adequately reflect the ongoing fixed asset costs of a sustainable physiotherapy profession.
96. At present, the closest equivalent to ORC is the facilities and set-up costs data provided by an NZSP member, as at Appendix III of the Deloitte Report (to which corroborating data should be sought). Feedback from the NZSP focus group indicates that a 4-bed clinic (for which data was provided) would be a tight squeeze for the typical physiotherapy practice size of 4.6 FTE as assessed in the model. However, NZSP advise that they are prepared to accept this as a reasonable approximation of the sustainable cost of clinic related fixed assets for the purposes of the Deloitte model.
97. We believe that the Reviewer should adopt the figures provided by NZSP to reflect a sustainable asset base for a typical practice. That data should then be incorporated into the final model as a basis for fixed assets, with additional allowance for motor vehicles and other fixed assets not incorporated in the NZSP data referred to above.

Exclusion of required working capital

98. Typically, working capital management is a key element of small, professional, service-oriented businesses. As working capital requirements will fluctuate within a period, it can be misleading to rely on period-end or point-in-time results as indicative of the funding requirements over an entire year.
99. The determination of ROI in the Deloitte model does not take into consideration the working capital (whether point-estimate or adjusted for seasonality) required to operate a physiotherapy practice. Owners/investors will also require a return (in addition to a return on fixed asset investments and goodwill) on this working capital. It should therefore be included in the Deloitte model.



100. In light of the sustainability aims of this project, it follows that the net working capital required to operate a sustainable physiotherapy practice in New Zealand must be positive. We estimate a 14-day discrepancy between accounts receivable and accounts payable. Thus, we consider that working capital should be estimated and applied at $14 / 365$, or 3.8% of total costs.

Potential understatement of goodwill and non-recognition of other intangibles

101. The model/approach taken by Deloitte uses an historic accounting-based measure of goodwill in order to gross up the total assets of the business for the purpose of the calculation of ROI. The use of historic goodwill (where generation of such goodwill is constrained by predominantly ACC-controlled revenues) as the basis for recognising all intangible assets of a physiotherapy practice implicitly assumes that historic operations are representative of future, sustainable operations.
102. In generally accepted accounting practice, goodwill is the residual of practice acquisition cost after deducting net tangible assets, whereas intangible value may have significantly increased due to operation of the business during the interim period. We consider that the use of historic goodwill arising on acquisition as a proxy for intangible value will significantly understate the value of all assets required for the operation of an economically sustainable physiotherapy practice.
103. We have noted that the use of an historic accounting-based measure of goodwill (recognised on acquisitions) does not capture all forms of intangibles inherent to the business. No consideration been given to other intangibles and off-balance sheet investments in infrastructure (for example, manuals on health and safety, professional practice protocols and procedures, training manuals, internally generated goodwill etc) that would lift the asset base of a sustainable physiotherapy practice.
104. We note that the IPAC report (2002) compiled by Deloitte used a different approach to that employed for this project to assess the level of goodwill appropriate for GP practices. In that instance, Deloitte used an industry benchmark of 25-33% of gross practice revenue to estimate goodwill for the purpose of determining the total assets and subsequent estimation of ROI.
105. Given the number of similarities between the operation of a GP practice and a physiotherapy practice in New Zealand, we consider that the approach employed by Deloitte for the IPAC report (2002) should also be carefully considered for adoption for the physiotherapy pricing project.



Adjustments for sustainable salaries

Introduction

106. NZSP advise us that they consider the Deloitte adjustment to be inadequate. They prefer the data identified by Strategic Pay, commissioned for this purpose. We have made some comments earlier on concerns regarding the sustainability of the profession. However, KPMG is not in a position to comment on the merits of Deloitte's adjustment as opposed to the Strategic Pay benchmark.

Current Deloitte Adjustment Process to Business Owner Remuneration

107. We understand that the data from the participating clinics was aggregated, normalised to a full year where required, and then averaged to find an average business owner salary for metropolitan, urban, and rural locations.
108. We find the use of different salary levels for metropolitan, urban and rural business owners inappropriate. This is not a distinction which is made elsewhere in the project. Moreover, it is not a distinction which will be made in ACC payments, which are flat rates across all practices.
109. The effect of flat rate payments provided by ACC would therefore mean that salary distribution in practice is likely to be the inverse of the staggered metropolitan, urban and rural salaries. That is, the likely outcome of this method would be to decrease salaries for those who have higher overheads (most likely metropolitan clinics), and potentially increase salary for those with lower overheads (most likely those in rural or other locations).
110. As noted above, Deloitte appear to have undertaken adjustments to the historical business owner salary in recognition of the fact that it is currently not sustainable. That adjustment appears to have been by adopting an estimate of current DHB "team leader" salaries and then adjusting these upwards by 25% to account for additional time worked.

Current Deloitte Adjustment Process to Salary Data

111. Deloitte also confirm that they undertake adjustments to salaries of clinical staff (Deloitte Final Draft Report page 20), both to incorporate time beyond 40 hours per week not captured in financials, and to account for benefits received in the public sector but not generally in private practice. It is unclear to us from the data we have seen exactly what level of adjustment was adopted to account for time not recorded in financials.
112. The key point is that Deloitte again does not use historic salary costs, but uses substituted costs, which it then benchmarks against DHB salary data.



Integration of sustainable salaries

113. We have designed our approach to allow Deloitte to continue to ‘back-out’ actual clinical staff labour expenses as provided by the survey practices, and replace these amounts with market-based data. We undertake separate analysis for business owners and for all other clinical staff, in accordance with Deloitte’s current practice.
114. As noted above, we believe that it is appropriate to report outcomes at the 87th percentile of price, in order to reflect an appropriate EPN price point. As explained in the section above (“EPN Should be Costed at High Percentile if Prohibition Remains”), we believe that this should be undertaken by including salary at the 75th percentile for all practices, making other adjustments, and then subsequently selecting the practice at the 87th percentile.
115. No other specific comments need to be made in respect of the integration of Strategic Pay’s business owner physiotherapist data, as that is a simple exercise. Refer to NZSP main submission.

Clinical staff

116. The Strategic Pay data identified salaries for clinical staff with three different levels of experience. Incorporating this into the Deloitte model therefore also requires use of experience / seniority data derived from the results of an NZPPA survey (refer data at Bundle tab 2).
117. As the Deloitte model only deals with a single “employed physiotherapist” salary level, we undertook the following analysis to determine the weighted-average sustainable salary, and thus the adjusted total labour expense, for clinical staff (excluding business owner-physiotherapists).
118. The NZPPA data included business owner-physiotherapists for the ninety-four practices that made up the survey. We therefore excluded ninety-four persons (which were assumed to be the most senior practitioners in each practice) from the appropriate survey categories. The relative percentages at each level of experience were then determined and applied to the total number of clinical staff (as provided in the Deloitte survey information – 53.5 FTE) to estimate the relative number of staff at each experience level. The following table sets out this analysis.

Clinical Staff					
Experience	Total	Adjustments^a	Adjusted total	Adjusted %	Clinical staff (per Deloitte survey)
0-4 years	71	(1)	70	25.1%	13.4
5-9 years	74	(5)	69	24.7%	13.2
10+ years	228	(88)	140	50.2%	26.8
Total	373	(94)	279	100.0%	53.5

^a Adjustments made taking into account that, of the 94 surveyed practices, one practice has no physiotherapists with more than 0-4 years experience and another five practices have no physiotherapists with more than 5-9 years experience. For all other practices, business owner-physiotherapists were assumed to have 10+ years experience.

119. The experience strata as per the NZPPA survey were equated to the following points totals (and roles) as determined by Strategic Pay.

Clinical Staff		
Experience level	Points total (per Strategic Pay)	Role
0-4 years	354	Entry-level practitioner
5-9 years	459	Mid-level practitioner
10+ years	545	Experienced senior practitioner



120. The weighted-average total remuneration (and thus total clinical staff labour expense) at both the median and upper quartile levels for clinical staff was then determined as per the following table.

Clinical Staff - Health Sector			
		Total remuneration	
Role	# of staff in survey	Median	Upper Quartile
Entry-level practitioner	13.4	\$52,488	\$55,297
Mid-level practitioner	13.2	\$67,082	\$73,511
Experienced senior practitioner	26.8	\$79,493	\$91,378
Weighted average		\$69,648	\$77,907
Total clinical staff labour expense		\$3,726,177	\$4,168,008

121. We consider that the weighted average of the three remuneration levels above should be the remuneration inserted into the Deloitte model as representative of sustainable labour costs for clinical staff. In particular, if price control is to remain, we consider use of the Upper Quartile (i.e. 75th percentile) of remuneration information should be used.

Other Cost Issues

122. NZSP is also concerned about the treatment of a range of cost items which they consider have not been properly assessed. NZSP are best placed to assess the actual costs of those items, and do so in their submission under the same heading as above.
123. We consider that an activity based costing model is only as good as its inputs. It is important in such modelling to be as thorough in capturing of costs as possible. This requirement for thoroughness is amplified in a situation such as the current EPN contract where the costing will set a firm price which cannot be increased or supplemented from other sources.



124. We therefore consider it important for the Reviewer to assess whether all key costs are appropriately captured in the Deloitte model, and if not, to rerun the model with those costs included.

Additional Labour Costs – Professional Development and Holiday Act

125. NZSP have pointed to continuing professional development (an average of 40 hours per year) and Holiday Act (extra week's holiday) as being issues which need to be incorporated into the model.
126. There is no doubt that the extra week of holiday is an additional cost compared to the survey period. It should therefore be explicitly incorporated as an adjustment to the historic data. Likewise we understand from NZSP that the continuing professional development requirements were not in force during the survey period, and this should also be explicitly incorporated as an adjustment to the historic data.
127. These additional amounts of time off will result in either:
- 127.1. replacement staff costs, most likely at higher locum rates; or
 - 127.2. loss in revenue due to appointments foregone during the staff member's absence.
128. As each of the factors listed has a one week duration, replacement staff costs can conservatively be estimated as 2% of labour costs for each relevant staff member for each item. We consider that loss in revenue would be likely to be greater than the 2% of labour costs, as it would represent loss of 2% of revenue per staff member per item.
129. If these are additional cost items which are not captured during the survey period, then we recommend that they be incorporated as such.

Other Contracts

130. We consider that the key systemic points highlighted by BWL apply to other contracts, such as ABP, vocational rehabilitation and so on. Those contracts should also have a regular assessment of remuneration, with arbitration provisions as necessary.
131. The EPN and regulation rates have had the benefit of a specific study programme assessing the costs of those areas of service. We consider that the same type of thorough investigation into and pricing of the other areas of practice is called for in setting their rates.



Conclusion

132. We hope that this information will assist the Reviewer in assessing the sustainable pricing of the physiotherapy profession.

A handwritten signature in black ink, appearing to read 'Troy W Newton', written on a light-colored background.

Troy W Newton

Director