

4. FINANCIAL MANAGEMENT OF THE RUN-OFF COVER SCHEME

4.1 Future liabilities of the Run-Off Cover Scheme

4.1.1. The estimation of the Commonwealth's liabilities under the Scheme in future years is an inherently imprecise process. The operation of the Scheme is likely to be characterised by a small number of claims of highly variable size. It is not possible to predict the costs of the Scheme with a high level of confidence. For example, the presence of a single very large claim in any given year could have a substantial effect on the total amount of ROC indemnity payments for that year.

4.1.2. The liabilities of the Scheme could be measured in a number of ways. It is normal for insurance-type liabilities to be measured on either a 'notified' or an 'occurrence' basis. On a notified basis, new liabilities would accrue to the Scheme as new claims were notified. On an occurrence basis, new liabilities would accrue to the Scheme at the time of the occurrence of the medical incidents which were expected to give rise to medical indemnity claims which would attract a ROC indemnity payment.

4.1.3. Under the occurrence model, liabilities are recognised more quickly than under the notified model. The occurrence model is more consistent with the notion that the Scheme is ongoing. Accordingly, the occurrence model has been adopted for this report. The liabilities of the Scheme are therefore taken as the present value of future ROC indemnity payments (including associated insurer claims handling expenses) which relate to medical incidents which occurred before the effective date of valuation.

Comment on experience during 2011-12

4.1.4. In any actuarial investigation it is appropriate to compare the emerging experience with that previously projected. This analysis informs the assumption setting process for the current investigation.

4.1.5. Based on input from industry actuaries and some judgement, the previous report estimated the incurred-but-not-reported (IBNR) Run-Off Cover Scheme liability at 30 June 2011 as \$44.5 million. Implied within that estimate was an expectation that approximately \$4.1 million in new notifications would emerge during 2011-12. The most recent actuarial estimates predict about \$4.4 million of notifications for 2011-12 and \$5.8 million for 2012-13.

4.1.6. In relation to Scheme-eligible claims which had been notified at the time of the previous review (30 June 2011), actuarial estimates of the corresponding ROC indemnity payments had a present value then of \$10.2 million. In 2011-12, claim payments of about \$2.1 million were made by MII/MDOs relating to these claims (based on industry data). All else being equal, this would suggest a residual figure at

30 June 2012 of about \$8.6 million in today's dollars. Up to date actuarial estimates put this number at around \$7.1 million (excluding 2011-12 notifications). Despite this, industry actuaries have taken a generally cautious view of future liabilities. Thus, industry projections of future notifications have generally increased when compared with the corresponding projections last year.

Changes to assumptions

4.1.7. We investigated the recent eligibility experience. Whilst our models continue to project higher numbers of eligible practitioners than the numbers reported by industry, there is substantial variability in the reporting of eligible practitioners among the insurers. Furthermore, the data can vary significantly between months of reporting, which undermines the reliability of the data. Accordingly, we have decided to leave our new entrant assumptions unchanged.

4.1.8. Claim cost and financial assumptions remain reasonable, based on a high level analysis of the experience to have emerged so far.

4.1.9. We have not changed in the way in which we have estimated the IBNR liability. For this review we have again based our IBNR estimate on industry actuarial estimates of future notified cost. We have used our claim reporting assumptions to split the estimates of future notified cost between past and future medical incidents. We have again added a margin to the base IBNR estimate in order to bring it broadly into line with our estimate of new accrual. We have maintained the margin of 20 per cent. We remain satisfied that the approach is reasonable.

4.1.10. Our estimates of new accrual are again derived from models developed in this office. In some of the previous reports we included a margin of 25 per cent in the new accrual estimates. Emerging reported experience has continued at a lower level than expected. This year we have not included any margin in the new accrual estimates. The new accrual estimates (net of any margin) are broadly consistent with the other liability estimates.

4.1.11. Appendix 4 sets out the main assumptions and describes the methodology that was used to estimate the liabilities. Appendix 5 looks at the effect of the High Cost Claims Scheme (HCCS).

Projected Run-Off Cover indemnity payments

4.1.12. This section sets out projections of ROC indemnity payments for the next 10 financial years. For the reasons described above, the projections should be regarded as indicative only. The data issues referred to earlier in this report also contribute to the uncertainty. The underlying assumptions and methodology are described in Appendix 4, with the calculations summarised in Table 15. Table 4 below sets out the projections, which are illustrated in Figure 4. The Scheme is not expected to become mature in a cashflow sense for many years. The payments projected below are in nominal dollars and have not been discounted to current dollar values.

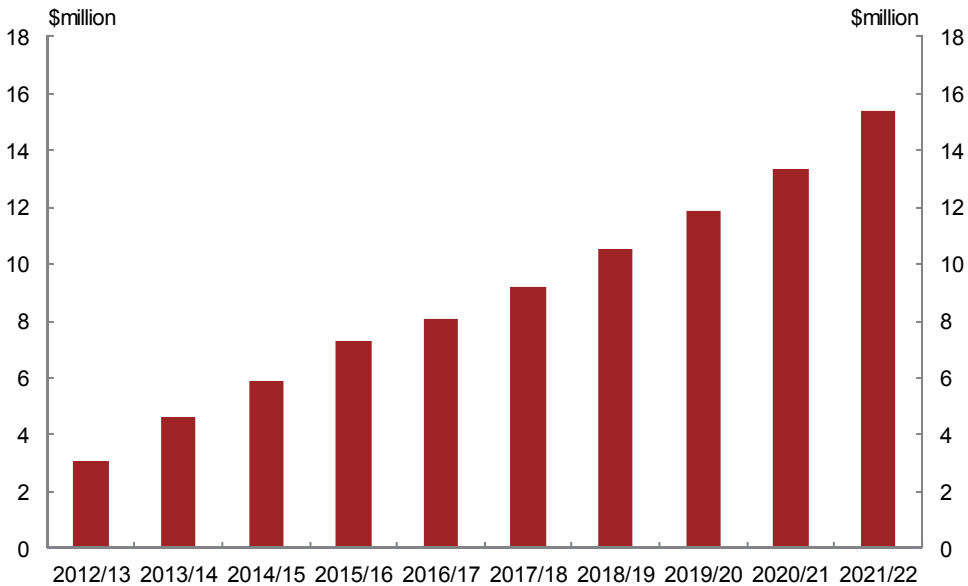
4.1.13. The projected payment figure for 2012-13 is a blend of actual payments to the end of April 2013 and projected payments for the year. Generally, ROC indemnity payments are assumed to be made at the same time as the corresponding claim payment. The estimates include indirect costs associated with handling claims, referred to as indirect claims handling expenses (CHE) (see paragraph 4.2.8).

Table 4: Projected Run-Off Cover indemnity payments (including CHE)

Year ending 30 June	Projected ROC indemnity payments plus CHE \$'000 ^(a)
2013	3,217
2014	4,637
2015	5,868
2016	7,270
2017	8,103
2018	9,199
2019	10,512
2020	11,909
2021	13,378
2022	15,396

(a) These projected payments do not include administration amounts payable to insurers under the ROC Claims and Administration Protocol.

Figure 4: Projected Run-Off Cover indemnity payments (including CHE)



4.2 Notional Account

4.2.1. The Scheme must be managed over a long time frame. As discussed previously, ROC indemnity payments are likely to be 'lumpy' in nature and immature in size for some years. ROC support payments will be received well in advance of ROC indemnity payments. As a result of the payment timing mismatch and the expected volatility in the ROC indemnity payment pattern, it is appropriate to have a system which enables proper tracking of the financial flows over time. Accordingly, a ROC notional account (the Notional Account) is maintained.

4.2.2. It is important to appreciate that the Notional Account is not an official Government account. Rather, it is a device established for the sole purpose of facilitating equity between practitioners and other taxpayers.

4.2.3. The Notional Account is credited with:

- ROC support payments;
- amounts to offset ROC indemnity payments which relate to doctors who were eligible at the commencement of the scheme; and
- notional interest.

4.2.4. Notional interest is credited to the Notional Account to ensure that practitioners derive the proper benefit of the time value of money since ROC support payments are received by Medicare Australia well in advance of any ROC indemnity payments being made by Medicare Australia. Notional interest is applied at the short term bond rate for consistency with section 34ZS of the Medical Indemnity Act which requires interest at the short term bond rate to be applied to the total run-off cover credit balances of individual practitioners.

4.2.5. On establishment of the Scheme, the Government announced that it would fund the opening liability that was attributable to practitioners who were already eligible for cover under the Scheme at the time of its commencement. Now that ROC indemnity payments have commenced, effect is given to this commitment by ensuring that the Notional Account is credited with amounts which offset any ROC indemnity payments which relate to doctors who were eligible at the commencement of the Scheme.

4.2.6. The Notional Account is charged with:

- ROC indemnity payments; and
- payments made under the ROC Claims and Administration Protocol.

4.2.7. The Scheme 'operates after' the HCCS. The HCCS meets 50 per cent of the excess above \$300,000 of the cost of individual large claims. For example, for a claim which costs \$1 million, the HCCS will pick up:

$$50 \text{ per cent} \times (\$1,000,000 - \$300,000) = \$350,000$$

4.2.8. The Scheme will also pay an amount to a MII or MDO to cover the indirect costs associated with handling claims, referred to as indirect claims handling expenses (CHE). The Scheme pays 5 per cent of the cost of each claim to cover CHE. Table 5 below describes how an eligible \$1 million claim would be funded. The total amount paid of \$1,050,000 includes claim costs of \$1 million and CHE of \$50,000.

Table 5: Funding sources for a \$1 million claim which is eligible for the Run-Off Cover Scheme

Funding source	Amount
HCCS	\$350,000
ROC indemnity payment (direct claim costs)	\$650,000
Run-Off Cover Scheme CHE	\$50,000
Run-Off Cover Scheme (Total)	\$700,000

4.2.9. Appendix 3 provides more detail on claim amounts eligible under the Scheme.

4.2.10. As noted earlier, the Medical Indemnity Act provides for payment of a practitioner's total run-off cover credit, should the Scheme ever be wound up without alternative arrangements being put in place. Thus, in this event, a large part of the

accumulated ROC support payment balance would become a liability of the Scheme. At the same time, since the Scheme liabilities are being measured on an occurrence basis, some of the liabilities of the Scheme would be released, partially offsetting this impact. However, for the purpose of this report, the Scheme has been assumed to be ongoing and the whole amount of the accumulated ROC support payments has been taken to be available to meet relevant ROC indemnity payments.

4.2.11. The liability estimates given in this report are central estimates. In broad terms, this means that they are intended to be equally likely to be too high or too low. In particular, it is not intended that the liability estimates contain any margin for risk. Funding considerations for the Scheme are not the same as for private sector insurance arrangements. The objective here is to manage the funding over the long term. Since substantial volatility in the liability estimates is likely from time to time, periods of surplus and periods of deficit in the Notional Account might be expected. However, given the long funding time horizon that is appropriate for the Scheme, a short term deficit in the Notional Account is not a cause for concern. As a result of this, there is no strong reason to maintain a risk margin in the liability estimates.

4.2.12. Table 6 below sets out the cashflow statement of the Notional Account for 2011-12.

Table 6: Cashflow statement of the Notional Account 2011-12

	\$'000
Income	
ROC support payments (received 30 June 2012)	13,506
ROC indemnity payments (in respect of doctors eligible at 1/7/2004 start up)	34
Notional interest	3,421
Expenses	
ROC indemnity payments (in respect of doctors eligible at 1/7/2004 start up)	34
ROC indemnity payments (in respect of doctors eligible post 1/7/2004)	2,736
Administration cost payments to MIs	1,392
Net cashflow	12,800

4.2.13. Table 7 below sets out the balance sheet of the Notional Account as at 30 June 2012.

Table 7: Balance sheet of the Notional Account as at 30 June 2012

	\$'000
Assets	
Cash as at 1 July 2011	144,909
Net cashflow	12,800
Total	157,709
Liabilities	
Outstanding compliance costs	2,600 ^(a)
Paid by MIs but not yet recovered from Medicare Australia	2,813 ^(b)
Notified to MIs but not yet paid by them	11,526 ^(c)
Incurred but not yet notified to MIs	53,791 ^(d)
Claims handling expenses	4,656 ^(e)
Total	75,386

(a) Estimate only — the amounts of some components of this liability are currently unknown.

(b) Based on estimates provided in relation to claims/incidents notified to MIs and MDOs by 30 June 2012.

(c) Based mainly on estimates provided by industry actuaries.

(d) Based on estimates provided by industry actuaries and models developed within this office.

(e) Based on 5 per cent of 'grossed up' ROC indemnity payments (to allow for the impact of the HCCS).

4.2.14. The Notional Account at 30 June 2012 has disclosed an estimated surplus of about \$82 million. Note again that no account has been taken for possible payments to practitioners under Subdivision E of the Medical Indemnity Act, should the Scheme be wound up without alternative arrangements being put in place. Generally, the estimated surplus position should be regarded as highly uncertain.

4.2.15. Finally, it is appropriate to provide a benchmark projection of the liabilities of the Scheme. Table 8 below sets out estimates of the liabilities of the Notional Account at the end of each of the next five financial years. The purpose is to illustrate the short-term development of the Scheme. There is very substantial uncertainty in these estimates. The numbers shown have been discounted to the end of the relevant financial year but have not been discounted to give values in today's terms. The projected liabilities are, in general, about 3 per cent higher than the corresponding amounts presented in last year's report.

Table 8: Projected balance sheet liabilities of the Notional Account

Year ending 30-Jun	Liability (\$'000)	New accrual (\$'000)	Interest cost (\$'000)	Payments (\$'000)^(a)
2012	75,386			
2013	87,890	10,655	5,066	3,217
2014	100,417	11,348	5,815	4,637
2015	113,208	12,086	6,574	5,868
2016	126,156	12,871	7,347	7,270
2017	139,910	13,708	8,149	8,103

(a) ROC indemnity payments plus CHE only. Does not include liability in respect of outstanding compliance costs. Refer Appendix 4 for further information.

4.3 Actuarial management

4.3.1. It is appropriate that the Scheme be subject to ongoing actuarial management.

4.3.2. Regular review of the costs and notional assets of the Scheme will allow the ROC support payment rate to be adjusted from time to time, if necessary. Consideration of that rate is beyond the scope of this report. This report has described a framework for the valuation of Scheme liabilities and established the Notional Account. It is intended that the valuation and accounting framework be applied at each future annual review of the Scheme.

A handwritten signature in black ink, appearing to be 'Peter Martin', with a stylized, flowing script.

Peter Martin FIAA
Australian Government Actuary
13 June 2013