# Appendix A

# Financial Model explanatory notes (relevant to rate proposal for 2015/16)

# March 2015

## 1. Introduction

1.1 To assess the fair cost of care for the purposes of proposing Residential and Nursing rates (“rates”) for 2015/16 financial year, Devon County Council (“DCC”), (“the Council”) proposes to use a Financial Model (“the Model”) that it developed itself, and employed last year to set rates for 2014/15. The Model considers the costs of staffing, repairs & maintenance, and non staff costs of providing care & accommodation. There is also consideration of the capital costs – the costs of financing a business with debt, and the return on equity element – and what would be a fair return to the business owner.

1.2 Data contained in the Model was sourced from analysis of staffing hours and appropriate banding of care needs, and informed by business information supplied by a small cross section of the Devon care home market during a year long programme of engagement with the provider market over 2013 and 2014, which was supported by business services firm EY.

1.3 The Council also considers its position as a significant purchaser and responsible commissioner in the Devon care home market, which is a mixed market of private and public purchasers. The Model DCC uses calculates the cost of care and accommodation, and a reasonable return for business owners, while at the same time accounting for Devon County Council’s position in the marketplace as a significant and continuous purchaser of residential and nursing placements.

1.4 In coming to a proposition on 2015/16 rates, the Council has applied sector specific inflation changes to the actual cost of care modelling values used to set rates for 2014/15.

1.5 The Council is not proposing to re run an exercise to determine the usual cost.

## 2. Summary and principles of approach

2.1 In its approach to setting 2014/15 rates, DCC looked to take a new approach to deriving an actual cost of care assessment to inform setting of its Usual Cost – the price the Council would usually expect to pay for banded care packages. This approach was heavily orientated to engagement with the care home provider market, including a series of open meetings and one to one business meetings with providers during 2013/14 financial year. DCC also considered other local and national information to support and challenge findings from provider engagement.

2.2 DCC developed an approach to setting rates which included carrying out :

- a series of one to one meetings during 2013/14 financial year with a representative cross section of the Devon care home provider market,
- a review of extant material,
- facilitated discussions during 2013/14 financial year to gather relevant information and opinions, and
- an analysis of the local market

2.3 Methodologies used to derive the Usual Cost and rates are described in detail in the following sections.

2.4 The proposed rates per bed per week for 2015/16 are presented below:

| | Standard | Enhanced | Standard + nursing | Enhanced + nursing |
|---|---|---|---|---|
| | £ per resident per week | £ per resident per week | £ per resident per week | £ per resident per week |
| **Proposed banded rates for 2015/16 (rounded to nearest whole £)** | **£442.00** | **£471.00** | **£586.00** | **£608.00** |

2.5 The Model models the cost of care and usual cost for social care only. Nursing care includes the addition of Funded Nursing Care ("FNC").

2.6 The rate for FNC is a national figure (currently £110.89) set by the Department of Health to pay for registered nursing care. DCC is not permitted under legislation to pay for or towards to cost of registered nursing care.

2.7 We have not made any assumption that FNC will be increased for 2015/16. If the Department of Health increases the value of FNC for 2015/16, the Council will carry that increase through to Nursing rates (although rates inclusive of FNC will need to be rounded to the nearest whole £pound).

2.8

The Council's analysis of supply and demand suggests that whilst sufficient supply exists in the Devon market as a whole, for both nursing and residential care, the margin between supply and the level of demand is narrower for nursing care. Therefore DCC proposes to pay a differential rate of return on capital for nursing placements to maintain sustainable nursing care capacity and to recognise the probable increased risk of a more regulated operating environment.

2.9 In consideration of setting a Usual Cost, DCC applies the following principles:

- secure best value for the public purse
- act a responsible commissioner
- pay no more than it would expect to pay

Therefore the Model considers:

- the market as a whole – a mixed market of DCC banded placements, NHS, Other Local Authority, and private individual placements
- that DCC should pay the marginal cost of a placement + an appropriate contribution towards the overheads (fixed costs) of an operation

- The greater the percentage of placements DCC buys, the more it will contribute towards the overheads of the business

# 3. Consideration and definition of Usual Cost

3.1 LAC (2004)20 (commonly known as 'the choice directive') defines "usual costs". This definition is understood to mean:

- The usual cost is the cost to the Local Authority – in other words the price paid to the provider;
- It represents what the authority "expects to pay". Because the Authority acts in a market, it is therefore a market based price which will take into account factors such as:
  - The capacity utilised by significant purchasers;
  - Market conditions including occupancy and the competitive environment.
- It should be "sufficient to meet the assessed care needs of supported residents in residential accommodation" and that implies:
  - The resources required to meet these needs are delivered by an efficient and well run home ( which is commensurate with the duty of the Council to secure best value services);
  - It must be sufficient to meet the direct care costs and associated accommodation costs. It therefore need not include payment of profit or return on capital employed but as explained below, these elements should be taken into account in creating a responsible purchasing strategy.

3.2 In setting a long term strategy as a responsible commissioner of services, and in determining a budget for care costs (with its implications for fee rates) Authorities are required to take account of other factors. This was stated in the case of Forest Care Homes Ltd et ors v Pembrokeshire County Council [2010]:

*"In seeking long term value for money and determining the budget available for specific social care services it is necessary for commissioners to take into consideration a whole range of factors, for example:*

- *The national or local economic environment may be making it difficult for some provider organisations to remain financially viable.*
- *A requirement to improve the quality of services may put a short-term strain on resources.*
- *The move to an outcomes-based approach may pose serious cultural as well as financial challenges.*
- *Recognition of the need for service providers to be able to recruit employees with the skills and aptitudes necessary to deliver good quality care, to provide them with the training they require to obtain qualifications relevant to their duties and to facilitate continuing professional development to extend their abilities.*
- *The need to re-train the workforce to respond to more up-to-date practices may have transition cost and service implications.*

*Thus, it will be important for commissioners, in contract, fee and service level negotiations, to recognise the financial and service challenges that are having an effect on providers, and consider both short and longer term scenarios."*

3.3 The above means that while neither the requirements of the National Assistance Act 1948, nor the definition of usual cost in association with the provision of preferred accommodation under LAC(2004)20 include of themselves a requirement to pay a return on capital employed, this does need to be taken into account in deciding the usual costs the Council expects to pay because the Council must have regard to the wider impact of its decisions. In effect it must set usual rates which it reasonably expects to be sufficient to maintain the financial viability of sufficient care homes to provide the care of the right quality which it needs to commission and to avoid undue disruption to the market and existing residents. There are, of course, many business models operating in the care market, and there is great variation of efficiency and scale within those models, but from the foregoing, it is clear that when usual costs are set, they should recognise the needs (including a return on capital) of a well run profit-making home where there is a sufficiently large market for it to maintain its occupancy at an efficient level. This is a difficult point as it could mean that a usual cost (including sufficient return on capital under the above definition) may not be enough to guarantee the future financial viability of all homes, particularly those which have higher than normal costs due to relative inefficiency, weak demand and/or highly competitive local markets. The Council must have regard to the impact of its decisions on residents and also providers, but the implication of what is said above is that it must strike a balance between a purely commercially based minimum price (but always subject to the need for the rate to cover at least the costs of actually providing care) and a price which sustains all businesses in operation however inefficient they may be, whatever their business model and however low their occupancy rate. This is also, of course, in line with the requirement under LAC(2004)20 to have regard also to Best Value requirements.

# 4. Methodology – care & accommodation costs

## 4.1 Wage rates

4.1.1 The wage rates input to the 2014/15 Model are **mean averages** of the Open Book provider sample ("the sample") hourly rates including employer on costs (holiday pay, sickness cover, employers National Insurance, and pension contributions with auto enrolment).

4.1.2 For care workers we have derived a composite hourly rate to represent the cost of care workers in the Devon market, encompassing both residential and nursing settings. The hourly pay rate used in the 2014/15 model is £6.76

4.1.3 **It is proposed for 2015/16 that the figure from 2014/15 is increased by the 3.0% uplift in the National Minimum Wage enacted on 1st October 2014 in order to reflect the probable need to maintain the differential of care worker hourly rates to the NMW. The proposed figure is £6.96**

4.1.4 We understand the table below to be typical employer on costs, which was broadly supported by Open Book discussions:

| | |
|---|---|
| Average percentage Employer NI contribution | 7.2% |
| Pension on cost percentage of salary for direct care staff | 2.0% |
| Working Time Directive minimum holiday on-cost | 12.0% |
| Statutory Sick Pay on-cost | 2.0% |
| Total direct staff on cost | 23.2% |

4.1.5 Catering, cleaning, and laundry staffing expenses were reviewed at Open Book meetings and the mean average of the sample used in the 2014/15 model was an allocation of £53.33 per bed per week.

4.1.6 **It is proposed for 2015/16 that the figure from 2014/15 is increased by the 3.0% uplift in the National Minimum Wage enacted on 1st October 2014 in order to reflect the probable need to maintain the differential of care worker hourly rates to the NMW. The proposed figure is £54.93 per bed/week.**

4.1.7 Management, administration, and reception staff, including head office or professional expenses were reviewed at Open Book meetings the **mean average** of the sample used in the 2014/15 model was an allocation of **£60.51** per bed per week.

4.1.8 **It is proposed for 2015/16 that the figure from 2014/15 is increased by 1.07% change in the Average Weekly Earnings (not seasonally adjusted) dataset for the Health and Social care industry. The proposed figure is £61.16 per bed/week.**

4.1.9 Agency staff usage was considered and we understand that operators may typically have to cover 1.5% of care worker shifts with agency staff at a double cost premium. **No change from last year's methodology is proposed, but the cost heading in the model increases in line with the cost of care staff as per 4.1.2 and 4.1.3**

4.1.10 Annual training of care staff was considered and we understand that operators may typically have to set aside the equivalent of **3 working days of care worker time. No change from last year is proposed.**

## 4.2 Staff Hours (direct care staff)

4.2.1 The care staff hours are likely to vary with the complexity and immediacy of the needs of residents at any one time. However when setting fee rates it is necessary to use an average expected allocation of hours on a per bed per week basis to provide a standard number of hours to be worked around.

4.2.2 The number of hours of care staff used in the Model is **20.5 hours** per bed per week for **STANDARD band**, and **24 hours** per bed per week for **ENHANCED band**. This does not take into account nursing time which is funded separately by FNC, which is the same position as the model for 2014/15 rates.

## 4.3 Repairs, replacements, & maintenance

4.3.1 The premise of this cost heading is that expenditure is incurred in maintaining a care home and its fixtures and fittings including equipment in working order; that the home is maintained in a steady state.

4.3.2 Although there were variances in this area of expenditure within the sample data of the open book exercise, reflecting the diversity of care home building in the county, i.e. older period buildings (e.g. Georgian or Victorian) appear to have significantly higher maintenance costs than modern structures, the exercise included a representative sample of the market, and so the **mean average** repairs, replacements, and maintenance figure was used for 2014/15 rates which was **£30.88 per bed per week**.

4.3.3 **It is proposed for 2015/16 that the figure from 2014/15 is decreased by 0.30% change in the September 2014 Consumer Prices Index component *04.3 Regular maintenance and repair of the dwelling*. The proposed figure is £30.79 per bed/week.**

## 4.4 Food, Utilities & Other Non Staff costs

4.4.1 Food expenditure was broadly consistent in the sample data although some providers did have much higher food costs due to a deliberate policy of sourcing high quality local foods. Whilst we wholeheartedly support the aspirations of premium food supplies, in the current financial climate for Local Government we have to be mindful that costs should be minimised where possible whilst still maintaining healthy balanced and nutritious food provision.

4.4.2 Therefore the **33rd percentile** of the sample, as opposed to the sample mean was used for 2014/15, which was **£29.45 per bed per week**. **It is proposed for 2015/16 that the figure from 2014/15 is decreased by 1.50% change in the September 2014 Consumer Prices Index component *01.1 Food*. The proposed figure is £29.01 per bed/week.**

4.4.3 Similar to maintenance costs, utility costs varied significantly across the sample, which we feel reflects the diversity of care home stock, with period buildings (particularly listed building where it is very difficult to refit to modern energy efficiency standards) which are not energy efficient costing much more to heat.

4.4.4 As we consider the sample to be a representative sample of the market, the mean average utilities cost was used in setting 2014/15 rates, which was **£25.45 per bed per week**. **It is proposed for 2015/16 that the figure from 2014/15 is increased by 3.57% weighted average change in the September 2014 Consumer Prices Index components listed below:**

- *04.4 Water supply and misc. services for the dwelling*: 37%
- *04.5 Electricity, gas and other fuels*: 59%
- *08.2/3 Telephone and telefax equipment and services*: 4%

4.4.5 The weighting percentages reflect the utilities expense profile in DCC in house homes. **The proposed figure is £26.36 per bed/week.**

4.4.6 There are many other individually low value cost headings which vary from business to business, which can be grouped as ‘Other non staff expenses’.

4.4.7 These typically include (but are not limited to): Handyperson/minor maintenance tradespeople, gardening, insurance premiums, medical supplies, equipment lease/rental, cleaning supplies, trade and clinical waste, CQC registration fees and DBS checking, advertising and recruitment, any training course fees, and continence products.

4.4.8 The values in the open book data used for 2014/15 rates were varied, but in seeking value for money for a representative rate for the type and level of care which we will seek to purchase, the **33rd percentile** of the sample was used which was **£36.22 per bed per week**.

4.4.9 **It is proposed for 2015/16 that the figure from 2014/15 is increased by 1.20% change in the September 2014 Consumer Prices Index *(Overall index)*. The proposed figure is £36.65 per bed/week.**

## 4.5 Occupancy

4.5.1 It is reasonable to expect care home operators to maximise occupancy, however due to the nature of the industry, full occupancy of 100% is generally unachievable.

4.5.2 As was used in the 2014/15 model and the Financial Model used in 2013/14 and 2012/13 before it, we believe it is reasonable to expect that an efficiently run care home could achieve 95% average occupancy in a functional and balanced market.

4.5.3 Provider data from the open book sample used in setting 2014/15 fees, and data received in March 2014 is mixed, however homes which appear to have efficient cost structures and are located in areas where supply and demand is balanced are operating at occupancy levels consistent with a 95% occupancy level.

4.5.4 The Financial Model assumes the recovery of fixed costs on the basis of 95% occupancy – i.e. the costs for a 50 bedded home would be recovered over an average bed use of 47.5 beds.

4.5.5 In terms of setting our usual cost we would not expect to pay for unoccupied rooms, howsoever caused. A weak market or conditions of oversupply in the market are commercial risks to which any business is subject.

# 5. Rate of Return on Capital Employed

## 5.1 Principles of Approach

5.1.1 The private sector’s return on capital needs to be set in its current context with regard to the provision of care home services.

5.1.2 The nature of elderly care is changing. Today there is far greater emphasis on personal choice which extends not only to questions about in which care home to reside but also to the choice not to reside in a care home at all. In response to this Devon County Council is playing its part in encouraging greater provision of care in an individual’s home (or near to them) so that they are not required to leave their local communities and support networks. DCC is also embarking upon an Extra Care Housing strategy which seeks to provide nearly 1,000 bed spaces in Devon.

5.1.3 The combination of these trends and actions will mean that the DCC funded market for residential care for the elderly frail will consolidate in the medium to long term. There is evidence that overall capacity exceeds demand in the care home marketplace with average occupancy levels in Devon estimated at circa 80%, reflecting a national trend.

5.1.4 Analysis of future demand trajectories for residential care reflect this consolidation of demand, and a level of oversupply in the market.

5.1.5 It is appropriate for business owners to receive a return for the capital employed in a well run business operating in a viable market. However, an appropriate return will not compensate for the market forces outlined above. DCC recognises that it is likely that capacity will have to rebalance in response to these market forces and that some businesses may not choose to or be able to adjust.

5.1.6 It is not the function of the return on capital employed figure within a usual cost to support an otherwise inefficient business or an over supplied market. It is, however, the function of this figure to be commensurate to supporting a viable and efficient market.

5.1.7 DCC has used a methodology in its Model which recognises two key principles:

- The rate of return should be based on a Weighted Average Cost of Capital (“WACC”) which reflects an efficient capital structure;
- The return should be based, as far as is practicable, on a realistic value of capital employed;

## 5.2 Required Rate of Return methodology

5.2.1 The Council proposes to continue using the same approach and methodology used in the Financial Model for 2014/15.

5.2.2 There is a common formula for calculating the WACC which works out the average percentage cost of financing a business whilst allowing for debt interest payments to be offset against taxation:

$$WACC = \frac{E}{V} * Re + \frac{D}{V} * Rd * (1 - Tc)$$

Where:

Re = cost of equity (shareholder return)
Rd = cost of debt (e.g. mortgage interest)
V = market value of operation
E = value of the equity i.e. value of shares
D = value of the debt e.g. outstanding mortgage
So: V = E + D
E/V = percentage of capital which is equity
D/V = percentage of financing which is debt
Tc = corporate tax rate (small companies rate 20%)

5.2.3 The cost of equity ‘Re’ can be calculated from another formula; the Capital Asset Pricing Model (“CAPM”). The formula is as below:

**Re = Rf + (Rm – Rf) x β**

Where:
Re = cost of equity
Rf = risk free rate
Rm = expected market return rate

β = beta value of the business entity (a measure of the systemic risk of an entity relative to the market)

5.2.4 For the residential market we propose not to use CAPM but instead use a figure of **12% as the cost of equity**. Providers have often cited 12% as the desired level of return on capital overall during discussions over 2012 to 2014, and also in Open Book meetings in 2013/14. We are prepared to use 12% for the equity proportion of capital.

5.2.5 For the nursing market we propose to use CAPM to calculate a cost of equity, consistent with the 2014/15 rates proposition. We propose a figure of **14.5% as the cost of equity**.

## 5.3 Explanation of Rate of Return values

5.3.1 In calculating the WACC, we propose a capital structure (i.e. debt : equity ratio) of **70% debt and 30% equity for residential, and 60:40 for nursing**. This value is predicated on the business principle of efficient capital structure, where businesses will seek to finance themselves at the lowest aggregate Cost of Capital. As the Cost of Debt ("Rd") is currently much less that the Cost of Equity ("Re"), it is rational for care home owners to fund as much of their capital as possible from debt, and invest their equity in alternative investments or to finance expansion.

5.3.2 There is a constraint on the level of debt dictated by typical Loan to Value ("LTV") ratios which can be obtained in the lending market at reasonable interest rates. Market research suggests that a LTV of 70%-75% is available at competitive interest rates.

5.3.3 The debt interest rate is that which is offered to business owners currently. Market research indicates that commercial mortgages are available at 2.5% to 3.5% over base. The bank of England base rate is still 0.5% as it has been since March 2009. Not all providers disclosed their debt interest rates in the open book exercise for 2014/15 rates, however the mean average of those who did is 3.5%.

5.3.4 Furthermore within the range, it is clear that some providers have opted for risk hedging or a degree of rate fixing, which while prudent financing strategies, have increased the actual rate which they were paying. Given that there has been no change to base rates, we propose to use **3.5% as the cost of debt interest**.

5.3.5 The tax rate we propose to use in the WACC formula is 20%. This is the HMRC's 'small profits' corporation tax rate for 2013 of 20%, which applies to profits up to £300,000 p.a. reflecting a market principally supplied by small operators.

5.3.6 Values proposed for use in CAPM are:

- A risk free rate of 4.50%, which is based on the approximate 10 year trailing average of long term UK government debt
- The expected market rate of return is 9.5% which gives a 5% risk margin for equity investments over the risk free return.
- Beta values for the care home sector are difficult to come by as even the largest operators are not publically listed. However we propose to use a **beta of 2.0** to signify that nursing care home operations is a business with double the level of risk as the market average.

5.3.7 CAPM values in the Model will therefore be (for nursing):

| | Risk Free Rate | Expected Market Return Rate | Beta Value used | = Required Rate of Return on Equity |
|---|---|---|---|---|
| Values | 4.50% | 9.50% | 2 | 14.50% |

5.3.8 The WACC calculations resultant:

Residential:

| Equity/ (Debt + Equity) | Required Rate of Return on Equity | | Debt / (Debt + Equity) | Debt Interest Rate | | Tax Rate | | |
|---|---|---|---|---|---|---|---|---|
| 30% | 12.00% | + | 70% | 3.50% | 1 - | 20% | = | 5.56% |

Nursing:

| Equity/ (Debt + Equity) | Required Rate of Return on Equity | | Debt / (Debt + Equity) | Debt Interest Rate | | Tax Rate | | |
|---|---|---|---|---|---|---|---|---|
| 40% | 14.50% | + | 60% | 3.50% | 1 - | 20% | = | 7.48% |

# 6. Capital Employed

## 6.1 Assessment of Capital Employed

6.1.1 The capital employed is considered as the value of the care home operation on a per bed basis.

6.1.2 The Model does not consider a separate capital return on the value of land on which care home stand, nor does it consider changes in the capital value of a business which may be affected by trading performance, bank lending policy, and macro economic factors.

6.1.3 Valuations of businesses have been hard to come by. Very little has been evidenced in the Open Book exercise for 2014/14 rates however a common value in both recently valued cases and where operators have declared an expected value, was £50,000 per bed.

It is probable that care home business valuations vary considerably due to varying business performance and geography, and perfectly feasible that the readily realisable value of a typical care home business is less than £50,000 per bed, but not withstanding these factors we propose to continue to use **£50,000 per bed as the value of capital employed** for the purposes of calculating a fair return on capital.

6.1.4 Furthermore DCC is not aware of any factors which suggest that capital value will have changed from values used in 2014/15 rate setting.

6.1.5 A value of £50,000 and WACC figures from above yield the following returns on capital:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Valuation of residential homes per bed | | £50,000 | x | 5.56% | = | £53.32 | per resident per week |
| Valuation of nursing homes per bed | | £50,000 | x | 7.48% | = | £71.73 | per resident per week |

# 7. Fair Market Pricing

## 7.1 Principles

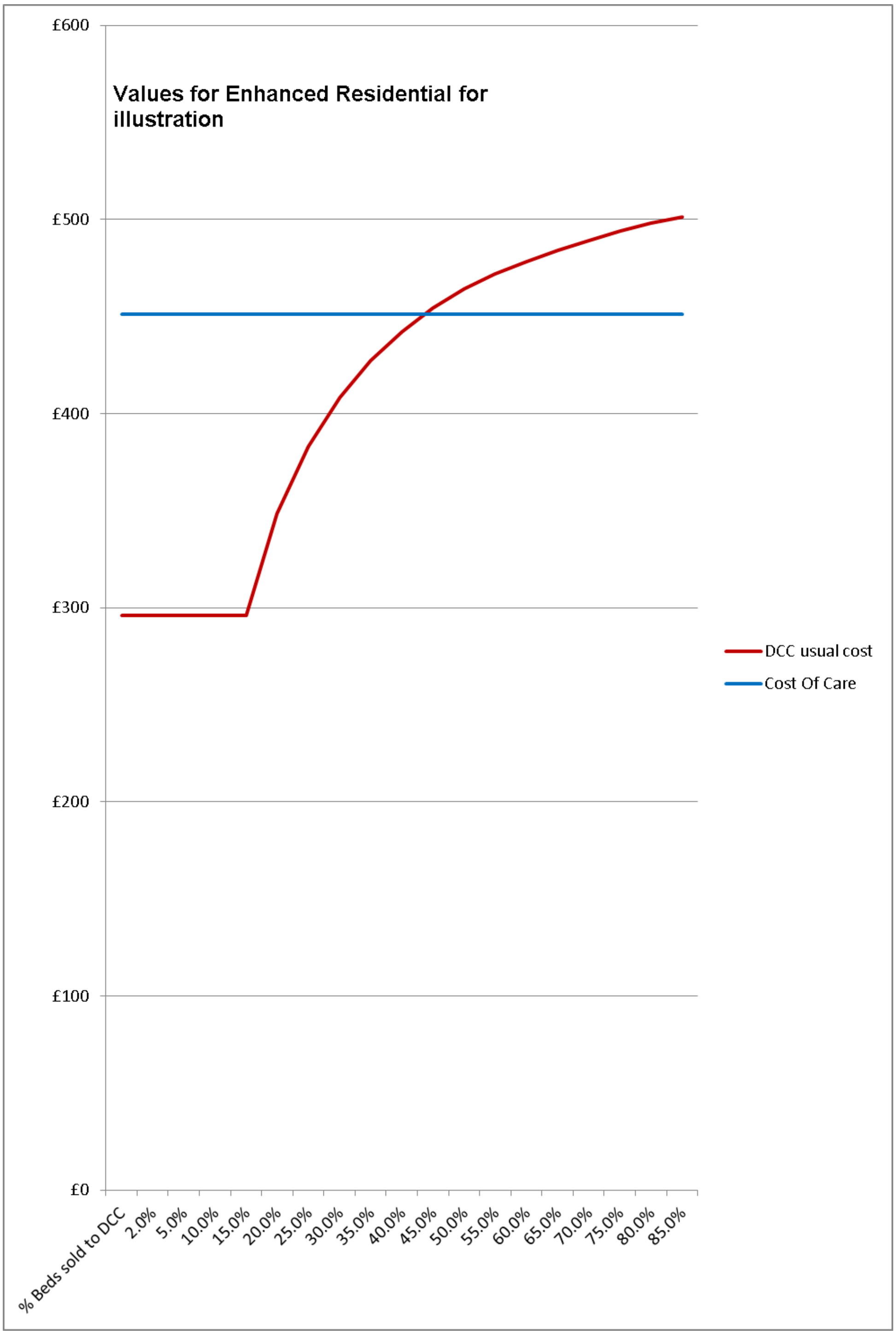
7.1.1 It is common commercial practice to offer different pricing structures for different sale volumes and different types of customer. Businesses are able to do this because the unit price calculations have to make assumptions about the anticipated volume of sales and their break even points. This means that one off buyers pay a fully absorbed cost often predicated on a pessimistic assumption of likely total sales whereas a purchaser making a large purchase reduces the operator's risk of achieving its target sales figures and this and other perceived benefits can be rewarded in the form of a lower unit cost price. This should not be seen as cross subsidisation of one buyer of another but the normal commercial practices that are evident throughout the commercial world. The Council has numerous examples of procurements in which it has been able to secure a discount against the unit cost prices of suppliers.

7.1.2 In these cases suppliers bid for such opportunities and make their own decisions about the benefits of winning the contract and the commercial discounts that they are prepared to offer. If they get it wrong it is at their own risk. In the case of care homes we are setting our usual rates and although it would be normal to expect that a significant purchaser such as DCC can secure commensurate discounts we have to also be aware of the impact of such decisions on the market and its sustainability. To do that we have to make some assumptions about break even points and model the influence of various pricing points on how a business recovers its costs.

7.1.3 To reduce commercial risk, some care home owners may choose to set their bed rates on the assumption of lower occupancies. The counter risk to the business owners is that it increases the unit cost beyond a point that the market will bear. However, in the Pembrokeshire ruling the judge reported evidence that some banks were looking for the costs of care and accommodation and the servicing of existing loans to be met at an 85% occupancy level. This would mean demonstrating to the bank that your prices have been set such that you can break even at 85% occupancy. We have used this assumption to derive the minimal market price for spot purchases using our cost model. We have then considered, according to DCC purchasing varying proportions of the overall bed stock from a home, what influence that would have upon the cost recovery required from DCC after the market price income has been taken into account. In other words we have tried to mirror the commercial pricing stance that a rational business owner might take and how that stance would combine to strike a fair bargain price with a responsible public purchaser, having regard to the need to sustain the market in both the short and longer term, as well as obtain good value for the public purse.

7.1.4 The following graph shows the position for a range occupancies within the 50 bedded home upon which the costs are assessed in the Model. It shows the average DCC bed rate (which represents the marginal cost and a fair contribution to overheads) which rises as the proportion of beds purchased in the home increases, because the responsible commissioner has to pay a higher proportion of the overhead costs and return on capital as it purchases more beds. Note that this responsible behaviour runs counter to the purely commercial purchaser who would expect to extract volume discounts as the scale of purchases rises.

Values used are for residential enhanced.



## 7.2 Limitations and safeguards

7.2.1 DCC estimates that it purchases on average 36% of the Devon market for care of Older People beds. However in some areas and some individual homes DCC buys a greater proportion of the available beds. This represents a risk both to the care home owners and to DCC. For the owners it may build dependence and an over-reliance on public sector income streams. In the current care climate where the Council is looking to reduce the numbers of people cared for in care homes and to provide suitable and, in the eyes of the services users, preferred alternatives, then this exposes them to significant income risk. For DCC it represents a risk that a home that is over-dependent upon its income will find it difficult to adjust to such care management driven changes and may experience reduced income leading to viability issues.

7.2.2 The Council recognises that this shift in the way that people are cared for will take some time and that some homes will, in the interim, continue to have an above average proportion of DCC beds. For this reason the Model applies the following two safeguards in the approach to setting the DCC usual costs:

- to set the usual cost at a 55% and 65% occupancy of the residential and nursing bed capacity (respectively), which is significantly greater than our current average;
- to set a floor for the rates that cover the care and accommodation costs. This means that regardless of the percentage of beds DCC commissions in any given home, DCC will always pay at least the cost of care and accommodation.

## 7.3 Application

7.3.1 The DCC market position as a significant purchaser means that the Council will be adding to the income of care homes and that care homes will be pricing for the private market to break even at 85% occupancy (possibly even lower in some cases). DCC's additional income allows occupancy to rise and for an income to be earned which is disproportionate to the additional costs incurred. This means that the care home owners will be making a super profit from the DCC residents. The following example serves to illustrate the point (note that this illustrates how a rational provider and responsible commissioner might act in the absence of "usual costs" being set in order to illustrate how a fair market price may be struck in these conditions).

7.3.2 A 50 bed care home prices its 'residential – standard' beds at £526 per bed week (based on 85% occupancy or 42.53 beds) to recover all its costs including return on capital. At a point in time it has an average of 42.5 private residents. All the costs for the home will be recovered. Subsequently, DCC is able to offer 5 nominations to that home which would take its occupancy to 95%. As all of the home's fixed costs will be recovered; the home only needs to charge a fee that will recover the additional variable cost of looking after the 5 new DCC nominations. This will relate to food and care costs and will be about £265 per bed week. If it charged the full fee then it would earn £261 (£526-£265) per bed per week as a direct profit (all other costs have been covered). This would equate to an additional profit of £1,305 per week or £68,043 per year.

7.3.3 From the home's perspective the minimum fee that could be charged in the above example is £265 per bed week – marginal cost, at no detriment to the home. If DCC offered £300 per bed the home would make a profit of £35 per week or £1,825 per annum.

7.3.4 There would be a significant difference in the fees charged to the rest of the market (£526 v £300) but a rational business model would not turn away this business because it was lower than the fully absorbed single room rate of £526, which is reflected in the pricing strategies of global businesses where occupancy is a factor e.g. hotels, airlines, cruises etc.

7.3.5 If however DCC were able to offer more nominations (to the extent that they displaced nominations from other market residents) then this additional contribution to profit would fall. It would be reasonable for DCC to recognise this and increase its fee rate accordingly. For each additional DCC nomination an increase in average fees would have to be negotiated.

7.3.6 The Model produces an average fee for a proportion of beds purchased within any single care home. If this proportion were set at 36% (to reflect the percentage of the Devon market purchased on average) then DCC would be paying a fair fee for the beds it occupied and would allow a home to reduce reliance on the private market in that the home would only need to find a further 59% occupancy (assuming a target of 95%) rather than 85% (the breakeven point of private market client occupancy). This situation is a material reduction in the operational risk of the care home business.

7.3.7 A further breakdown of how the Pricing dimension works is included below, this time using Standard + nursing for illustration:

| **Standard + Nursing** | |
|---|---|
| Total Beds | 50 |
| Occupancy Rate | 95% |
| % Beds sold to DCC | 65% |
| Beds Occupied | 47.5 |
| Market Beds Sold | 15.0 |
| Market Bed Rate | 705 |
| Market Income | 10,574 |
| Market Variable Costs | 6,106 |
| Cont To Fixed Costs | 4,468 |
| Total Fixed Costs | 10,768 |
| Cont to Fixed Costs Required | 6,300 |
| Beds sold to DCC | 32.5 |
| DCC Contribution to Fixed Costs per bed | 194 |
| Variable Costs per bed | 407 |
| **DCC usual cost** | **601** |

The number of private rooms sold

Assumed individual market fee rate (breakeven @ 85% occupancy)

15.5 x £653 = total income from individual purchasers

Variable costs attributable to the 15.5 beds sold to the individuals market

What is left over to pay towards the **total** fixed costs of the home

The total fixed costs of the home

Fixed costs not covered by individual purchaser income that DCC must cover

No of beds DCC is buying

Fixed costs that DCC must fund (per bed)

Variable costs that DCC must fund (per bed)

# 8. Dampening

8.1 DCC introduced a new rate structure for 2014/15 and therefore 2013/14 to 2014/15 mapping of beds was not appropriate, however DCC was keen to avoid any single provider becoming worse off as a result of the new rates.

8.2 This would have been the case in respect of service users moving from the 2013/14 N1 nursing band to the 2014/15 standard+nursing band. To avoid this situation a dampening figure of £7 per bed/week was added to that rate.

8.3 It was made clear at the time that the dampening element was ex-gratia, and therefore could not be considered permanent. However the Council is now proposing to permantise the dampening figure of £7 per bed/week brought forward from the 2014/15 rate structure for 2015/16 rates.

# 9. Additional uplift

9.1 The Council is offering an additional uplift of 1.5% of the previous year's rates to assist providers with possible future changes in the sector which may come about from the Care Act, and to invest in the future for those who work in the care industry.

# 10. Financial Model summary table

**DCC Financial Model for banded rates - 2015/16**

| | Standard | Enhanced | Standard + nursing | Enhanced + nursing |
|---|---|---|---|---|
| | £ per resident per week | £ per resident per week | £ per resident per week | £ per resident per week |
| **A) STAFF INCLUDING EMPLOYERS' ON-COSTS** | | | | |
| Funded Nursing Care (set by Dept of Health) | £0.00 | £0.00 | £110.89 | £110.89 |
| Care assistant staff cost per resident (including activities) | £175.78 | £205.79 | £175.78 | £205.79 |
| Catering, cleaning and laundry staff | £54.93 | £54.93 | £54.93 | £54.93 |
| Management / administration / reception/head office support staff | £61.16 | £61.16 | £61.16 | £61.16 |
| Agency staff allowance - nurses | covered within FNC | | | |
| Agency staff allowance - care workers (1.5%)] | £2.64 | £3.09 | £2.64 | £3.09 |
| Training backfill (3 days pa) | £2.97 | £3.36 | £2.97 | £3.36 |
| **Total staff** | **£297.48** | **£328.33** | **£408.37** | **£439.22** |
| **B) REPAIRS, REPLACEMENTS & MAINTENANCE** | **£30.79** | **£30.79** | **£30.79** | **£30.79** |
| **C) OTHER NON-STAFF COSTS** | | | | |
| Food | £29.01 | £29.01 | £29.01 | £29.01 |
| Utilities (gas, oil, electricity, water, telephone) | £26.36 | £26.36 | £26.36 | £26.36 |
| Other Non Staff Costs | £36.65 | £36.65 | £36.65 | £36.65 |
| **Total non-staff current expenses** | **£92.02** | **£92.02** | **£92.02** | **£92.02** |
| **Care & accommodation costs** | **£420.29** | **£451.14** | **£531.18** | **£562.03** |
| **D) RETURN ON CAPITAL** | **£53.32** | **£53.32** | **£71.73** | **£71.73** |
| **Fully Absorbed Costs at 95% occupancy** | **£473.61** | **£504.46** | **£602.91** | **£633.76** |
| Fully Absorbed Costs at 85% occupancy | £525.91 | £560.39 | £670.42 | £704.90 |
| Variable Costs | £265.33 | £296.18 | £376.22 | £407.07 |
| Fixed Costs | £208.28 | £208.28 | £226.69 | £226.69 |
| Dampening adjustment from 2014/15 rate changes | | | £7.00 | |
| **Usual cost** | **£435.33** | **£464.18** | **£579.22** | **£601.07** |
| **Additional uplift (1.50%)** | **£6.42** | **£6.84** | **£6.90** | **£7.23** |
| **Proposed banded rates for 2015/16 (rounded to nearest whole £)** | **£442.00** | **£471.00** | **£586.00** | **£608.00** |

This line assumes that operators will set the price they charge individual private purchasers at a level at which they can break even at 85% occupancy, i.e. fixed costs would be fully absorbed at