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Affinity's submission to the ACCC Childcare Inquiry – September 2023 Interim Report

1 Introduction

Affinity Education Group Limited (**Affinity**) welcomes the opportunity to comment on the Australian Competition and Consumer Commission's (**ACCC**) interim report for the Childcare Inquiry (the **Inquiry**) (the **Interim Report**).

As recognised by the Productivity Commission in 2015, for-profit Early Childhood Education and Care (**ECEC**) providers such as Affinity, are the primary source of the growth in early childcare capacity in Australia, and are best placed to continue to be a source of the required capital to establish new services, and expand existing services, in response to changes in demand.[1] Affinity makes this submission to assist and support the ACCC with developing policy proposals that address the identified shortcomings in the sector, while maintaining sufficient commerciality to incentivise further investment in the industry so that for-profit ECEC providers can continue to ensure the much-needed growth in supply and capacity of the Australian ECEC sector.

Affinity broadly supports most of the ACCC's findings and recommendations set out in the Interim Report. In particular, Affinity shares the ACCC's observations of the following features of the childcare sector:

- the significant land and labour costs that constitute approximately 85% of a for-profit ECEC provider's cost base;
- the importance of non-fee factors and their implications in parental decision making when choosing a childcare centre;
- the importance of ensuring a sustainable supply of trained staff to both alleviate cost industry pressures and deliver a high-quality service to families; and
- the complexity of the current Child Care Subsidy (**CCS**) system and market distortions it has created as a result of subsidy calculations being misaligned with the industry convention of daily practice.

In this submission, we comment specifically on findings 1, 2, 4, 6, 9, 10 and 13, as well as recommendations 1, 2 and 7 of the Interim Report, which are the topics Affinity believes it is well-placed to contribute to.

ABN: 37 163 864 195

[1] Productivity Commission Inquiry Report, Childcare and Early Childhood Learning: Volume 2, 31 October 2014, page 351

2 Affinity's comments on the ACCC's findings

2.1 Finding 1 – Labour is the main driver of cost for supplying childcare

We agree with the ACCC's finding that labour is the most significant cost of providing childcare. In Affinity's experience, a significant portion of these labour costs arise from the structure of the labour market, which is out of the control of ECEC operators on the basis it is largely influenced by government regulations and policies, namely: legislated workforce requirements, accreditation pathways, and the award rate system. Affinity is supportive of these regulations and policies as they promote the safety and well-being of children in care and the ECEC workforce. However, in considering the fee decisions of ECEC providers, it is important to note the impact of these regulations on the cost base of ECEC providers.

(a) Legislated workforce requirements

Educator-to-child ratios are legislated workforce requirements which have a key influence on labour market dynamics in the ECEC sector, and ultimately, the costs of operating a childcare centre. As recognised by the ACCC in the Interim Report, the significant cost difference between centre-based care compared and outside school hours care reflects the differences in educator-to-child ratios.

In addition to educator-to-child ratios, differences in state-by-state Early Childhood Teacher (**ECT**) requirements and incentives also influence labour costs. For example:

- New South Wales has materially higher ECT requirements that any other state, such as in NSW a 75 place centre requires 3 full time ECTs while in other States a 75 place centre requires 1 full time ECT + a second ECT for 3 hours of the day. For centres above 80 places, NSW requires 4 full time ECTs, while in other States a centre above 80 places requires 1 full time ECT + a second ECT for 6 hours of the day, which increases labour costs for these employees. Further, ECTs are paid higher than educators, which makes the total labour cost of an operator in NSW higher than any other state. The findings in the NSW Productivity Commission's report on the evaluation of NSW-specific early childcare regulations contains further details on this point.[2]

- Victoria offers relocation incentives of up to $50k to attract ECTs, which may have contributed to ECT shortages in other states, and ultimately increased labour costs in those other states.

(b) Accreditation pathways

Centre educators are primarily accredited through the TAFE system, and ECTs received accreditation through universities. However, despite demand for early education growing considerably, ACECQA's NQF Annual Performance Report 2022 that found that enrolment and completion figures for early education-related qualifications have declined or flat-lined over the last 5–10 years. The shortage of supply of educators has seen the rate of pay being offered by operators and demanded by educators in order to attract and retain staff increase substantially in more recent times. Educators are attracting significant premiums over award rates along with increasing attractive benefits and conditions.

(c) Award rate system

Most early education workers are either paid award rates or at a rate that references an award rate (e.g. 10% above award). As such, the annual Fair Work decisions relating to award rates directly impact the labour cost of early education operators. We note that the aggregate award rate increases from 2018–2022 amounted to 16%, which excludes growth in superannuation rates and payroll taxes in some states. In addition, the higher award rates for ECTs operating at a pre-school or primary school compared to a long day care centre combined with an ECT shortage has meant that long day

[2] New South Wales Productivity Commission, Evaluation of NSW-specific early childcare regulations, December 2022, page 14.

care operators have needed to offer comparable rates to pre-schools to attract ECTs, which has led to further labour cost growth.

2.2 Finding 2 - Land and related costs are the other significant driver of cost for centre based day care providers

Similar to our response to Finding 1, land costs are largely out of the control of early education operators as they are primarily driven by the property market.

As observed in the Interim Report, most children attend a centre that is 2 km–3 km from their family home. This means that most centres are in areas where the alternate use for the land is typically residential housing. From this, operators are subject to land value inflation and the associated housing affordability challenges being experienced across Australia. The implications of higher land values translate to high rental increases through the contractual periodic market rent reviews that typically occur every 5–10 years.

2.3 Findings 4 and 6 - Influences of location on supply and demand

We agree with the ACCC's finding that geographic locations, and the associated socio-economic demography of those locations, have a material impact on the supply and demand in that area. We wish to add that, in addition to the factors recognised by the ACCC, there are further key considerations that ECEC operators such as Affinity evaluate when considering whether to develop a childcare centre in a particular catchment area. These factors are the supply-demand dynamic, population growth, and population size.

(a) Supply-demand dynamic

The supply-demand dynamic of an area is typically measured by the ratio of children aged under 5 to the number of long day care places in the area. Higher ratios typically signify material demand, which generally encourages supply by way of an ECEC operator deciding to develop a childcare centre in that area.

(b) Population growth

Related to the supply-demand dynamic, the faster the population of an area is growing, the higher the likelihood is that an operator will be able to maintain high occupancy of the centre, such that entry to this area is a commercially rational decision.

(c) Population size and participation rate

Population size and participation rate determines how many centres the area can viably support and particularly impacts remote areas. For example, a catchment that has a population of 5,000 people, of which 300 are aged 0–5 (based on national average of 6%) may appear to have a high ratio of children to childcare places. However, under the current national average of long day care participation (around 45%) suggests that only 130–140 children may require care (for only 3 days per week, as per the national average). Thus, the actual size of a population becomes a critical factor in an entry decision.

Affinity encourages the ACCC to also consider the above factors in their analysis and we are confident they will help further explain the differences in the supply of centres between areas.

2.4 Finding 10 - Occupancy as a key driver of revenue

We agree with the ACCC's finding that occupancy is a key driver of revenue for childcare providers, and relatedly, has a significant impact on profitability and viability. However, Affinity also notes that market occupancy has been flat since 2017.

Based on our calculations using the Department of Education's quarterly industry reports, market

occupancy declined from 78% in 2014 to 76% in 2017 to 75% in 2022.[3] The fact that occupancy appears to have been flat for the average centre has meant that operators have instead had to rely on fee increases to recoup their increasing cost base Further, new supply has absorbed the growth in demand from 2017 to 2022. This additional supply has also increased competition for the scarce resources of land and labour, which amplified the cost base pressures

2.5 Findings 9 and 13 – Profitability of childcare centres and impact of the Child Care Subsidy (CCS)

Figure 3.6 of the Interim Report shows that for-profit provider-level margins have declined from around 15% in 2018 to around 9% today, which implies that the sector's fee growth has not been sufficient to offset the sector's cost growth discussed above. Figure 3.13 shows that centres in areas that fall under Socio-Economic Indexes for Areas (**SEIFA**) deciles 9 and 10 have experienced service-level margin compression and the lowest fee growth in the sector from 2019–2022. SEIFA deciles 9 and 10 correspond to high income areas that typically have high fees. While not explicitly explored in the report, we expect that these centres, particularly those in SEIFA decile 10, were close to the fee cap in 2019 and so their fee growth was closer to the growth in the fee cap over that period (around 8%). We have selected these charts to demonstrate that the fee cap has worked to place downward pressure on fees, when fees have been close to the cap.

However, this has been achieved at the expense of the viability of the operator and does not appear to have resulted in improved affordability outcomes for families in those areas, as demonstrated by table 3A.23 in the Productivity Commission's 2023 report on government services.[4] With the average sector rate now approaching the fee cap, it is important to make the appropriate adjustments to the funding system to ensure the early education sector remains sustainable and to prevent what happened in SEIFA decile 10 from 2019–2022 from occurring to the rest of the market. We will discuss this topic further in our comments on recommendation 2.

3 Affinity's comments on the ACCC's recommendations

Affinity is supportive of recommendations 1, 2(a)–2(c) and 3–6.

We understand that recommendations 2(d) and 7 are exploratory in nature at this stage, with the ACCC recommending further consideration of these measures. However, to assist the ACCC in its consideration of policy proposals, we provide high-level comments on recommendations 1, 2, and 7.

3.1 Recommendation 1 – Governmental clarity in policy objectives when determining mechanisms to influence price

We agree that clarification of government objectives and priorities when designing policy and regulatory frameworks will lead to a better functioning early education system. The objectives of affordability, quality, operator viability, higher industry wages, and value for money for the taxpayer are in conflict, and as recognised by the ACCC, require a trade-off.

There is a limit to the amount of cost an ECEC provider can bear before it reaches the shutdown point and becomes unviable to operate. As such, achieving the objectives of quality and higher industry wages (which increase the cost base) necessarily comes at the expense of the objectives of affordability and operator viability. For example, we note that given an average profit margin of 6% for not-for-profit operators, a 9% increase in pre-tax costs with no consequent change in fees or occupancy (which has been flat since 2017) would result in the average not-for-profit operator becoming unviable.

[3] The Australian Government Department of Education quarterly reports on usage, services, fees and subsidies are available here.

[4] Productivity Commission, Report on Government Services 2023: Child care, education and training, available here.

3.2 Recommendations 2(a), 2 (b) and 2(c) – Further consideration of changes to the Child Care Subsidy and existing hourly rate cap mechanism, to simplify their operation and address unintended consequences

Affinity is supportive of recommendations 2(a), 2(b) and 2(c).

In relation to 2(a), as discussed in our response to findings 1 and 2, increases in land and labour costs, which account for around 85% of an operator's cost base, is effectively out of an ECEC operator's control. As such, we agree that the indexation methodology should be amended to capture, and correlate with, the increases in these areas as it will allow for increases to the cost base to be shared between the operator, government and families, rather than being primarily borne by families through fee increases above the cap. In addition, it will allow for services close to or above the cap, such as those discussed in our response to findings 9 and 13, to remain viable over the long-term. Lastly, we note that from 2018–2022, the fee cap increased by only 8% while the average cost per hour for an operator increased by 27%.

In relation to 2(b) and 2(c), we agree that the hourly rate cap should align with the industry practice of daily pricing. The hour-based conventions in the CCS have always been inconsistent with the day-based pricing conventions in the industry and this recommendation will simplify the funding system and make it easier to understand for families. Furthermore, we are confident it will result in improved outcomes for families through:

- lower out-of-pocket costs for families, as they no longer have a reason to "limit" session length to maximise subsidised days; and

- greater accessibility of subsidised care, particularly for families with low activity hours.

3.3 Recommendation 2(d) – Further consideration of including a stronger price monitoring role by government supported by a credible threat of intervention to place downward pressure on fees

. To assist the ACCC's further consideration of this recommendation, we outline the following key factors that in our view would be important to consider in designing and implementing any policies and regulations relating to price monitoring:

- **Determining when a fee is "excessive"** – How and when will a fee be considered excessive? Will it be calculated according to a framework or formula that varies by area based on localised cost benchmarks, or will it be a market-wide rate like the CCS fee cap?

- **Valuing non-price factors** – As recognised by the ACCC, non-price factors are a strong driver of consumer choice in the ECEC sector, relative to other industries. How will these non-price factors that parents value be considered?

- **Monitoring architecture** – Monitoring regimes often come at a significant cost to both the government, and industry participants being monitored. The architecture of a reporting system to price monitor approximately 9,000 childcare centres across Australia, and the associated regulatory requirements, will be a key issue.

- **Differences in cost base between types of providers** – How will the economic differences between not-for-profits and for-profits be considered? For example, not-for-profits receive payroll tax exemptions, sometimes grants or favourable lease terms, and do not have the need to generate a commercial return that for-profits have.

- **Variations on fees depending on location** – How will the significant variation in fees between different areas be accounted for, noting the finding that fees vary widely depending on an area and its socio-economic demographic?

- **Credible threat of regulatory intervention** – How would the threat of credible regulatory intervention be tied to price monitoring? and what would the potential intervention be?

3.4 Recommendation 7 – Further consideration of supply-side subsidies and direct price controls

We understand the ACCC is still considering whether supply-side subsidies and direct price controls are required. At a high level, we note that any direct price controls which limit the ability of providers to increase fees (in order to recover increasing costs) will need to be matched with a supply-side subsidy such that there continues to be sufficient commercial incentive for the entry and expansion of for-profit providers to service Australia's growing demand in the ECEC sector. Affinity notes the ACCC's acknowledgement of the requirement for, and benefit of, increased supply-side subsidies in any introduction of a price control mechanism. For example, the recognition that the gross fee reduction in OECD countries is attributable to those countries providing significant supply-side subsidies, as compared to Australia. We look forward to providing further feedback on policy proposals as and when they are made available for comment.

Regards,
Cathy Montesin

Chief Financial Officer
Affinity Education Group