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Budget 2019 Information Release
August 2019

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Capital system settings in the DHB sector

Date:	28 February 2019	**Report No:**	T2019/354
		File Number:	ST-2-4-2

Action Sought

	Action Sought	**Deadline**
Minister of Finance (Hon Grant Robertson)	**Agree** to recommendations	N/A
Minister of Health (Hon Dr David Clark)	**Agree** to recommendations	N/A

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
Kerry Hollingsworth	Principal Advisor Investment Management and Asset Performance	[39] (wk)	[23] (mob)	✓
Davin Hall	Principal Advisor, Health team	[39] (wk)	[23] (mob)	
Carolyn Palmer	Manager, Health team	[39] (wk)	[23] (mob)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Refer the report to the Minister of State Services Hon Chris Hipkins, for his information

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Capital system settings in the DHB sector

Executive Summary

This report sets out the Treasury's views on the effectiveness of current capital system settings in the DHB sector including work under consideration or in progress. It also proposes working closely with the Health and Disability System Review (the Review) to develop and test options to future-proof capital management practice and performance in that sector.

In June 2018 joint Ministers asked the Treasury to report back to them on the effectiveness of the existing capital system settings in the DHB sector, including the capital charge and depreciation funding, and evaluate any alternative options for ensuring efficient and sustainable use of capital in that sector.

At that time there were immediate concerns about the pressure of capital charges on DHB baselines (and management practices), and the condition of some property at Middlemore Hospital (Counties-Manukau DHB). We advised then that we thought these are symptoms of deeper issues with capital settings in the sector. Our view is that the combination of current processes, rules, capabilities, incentives and information requirements affects the behaviour of parties in the DHB sector so we need to look at the way those aspects of the system work together.

In mid-2018, the Minister of Health established the wide-ranging Health and Disability Services Review (the Review) to future-proof government's health and disability services. The Review offers great potential for improving capital management in the sector.

Since then there have also been other related developments (T2018/1968 and T2018/3226 refer). These include:

- A decision by Joint Ministers to reallocate $5 million from the Health capital envelope to an asset management improvement programme led by the Ministry of Health.
- Agreement in principle from the Minister of Health to establish a new Health infrastructure planning and delivery function within the Ministry entity.
- An in-depth Treasury study for the Director-General of Health of current and required investment management capabilities in the Ministry of Health itself.

Once implemented each of these recent steps should help to improve the way the DHB sector manages its capital resources and delivers health and disability services. These are necessary but not sufficient changes to capital settings in the DHB sector.

None of them directly addresses the institutional arrangements that drive capital management behaviour in the DHB sector. These institutional arrangements – between the government, the ministry and individual DHBs - have a profound impact on how scarce capital resources are managed and are best considered within the scope of the Review.

We recommend Ministers jointly agree that the Treasury will work closely with the Review as it explores options or proposals for future-proofing the Health System ahead of its scheduled interim report in August 2019. In particular, the Treasury will provide information and advice on the potential capital management implications of options, building off its work to date.

In the meantime, and until there is clarity over the broader institutional arrangements we also recommend Ministers agree to retain the capital charge regime but modify it to allow DHBs to be directly funded for the extra capital charge expenses associated with new capital injections (except for deficit support). This would bring the DHB sector in line with what already happens in departments.

This proposed change in policy represents a significant change in policy from the current position in which individual DHBs have to bear the extra cost of capital charge expenses associated with capital injections through their share of the population-based funding formula (PBFF).

That change will alleviate some immediate cost pressures on some DHBs (particularly Canterbury DHB and West Coast DHB) and bring the policy and practice into line with current practice in government departments when capital injections result in an increase in the level of service (and hence costs of services provided).

The fiscal effects of this change in policy are being considered in Budget 2019. If Budget Ministers agree, this change in policy can take effect immediately. The immediate impact of this change in policy on the operating allowance would be around [33] per annum ongoing [33] in 2019/20). This sum relates to new capital charge expenses that will be incurred from 2019/20 when capital injections for approved investments are drawn down.

Recommended Action

We recommend that you:

a **note** that the Ministry of Health is taking action to address particular capability and governance issues in the current DHB system, including work on a national asset management plan, aspects of the Ministry's own capability and the role of the Capital Investment Committee

b **agree** that the Treasury will directly assist the Health and Disability System Review by providing information and advice on the potential capital management implications of any options or proposals for future-proofing the Health System

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Health

c **agree** to retain the capital charge regime and adjust it to allow DHBs to be directly funded for any new capital charge expenses associated with the drawdown of capital injections that result in an increase in the level of service (but excluding any deficit support) from 2019/20 onwards

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Health

d **agree** that the funding implications of the policy change in c above will be considered in budget processes

Agree/disagree.
Minister of Finance

Agree/disagree.
Minister of Health

e **note** that there is an initiative in Budget 2019 to address any new capital charge cost pressures in FY 2019/20 as a result of the drawdown of capital injections, and

f **refer** to the Minister of State Services Hon Chris Hipkins, for his information.

Refer/not referred.
Minister of Finance

Refer/not referred.
Minister of Health

Carolyn Palmer
Manager, Health & ACC

Hon Grant Robertson
Minister of Finance

Hon David Clark
Minister of Health

Treasury Report: Capital system settings in the DHB sector

Purpose of Report

1. The main purpose of this report is to explain why there needs to be a comprehensive approach to improving the effectiveness of current capital system settings in the DHB sector, leveraging insights from recent work. The report lays out alternative options for ensuring more efficient and sustainable use of capital in the DHB sector.

Context

2. In June 2018 we reported on the capital charge regime in the DHB sector and the scope for further work on broader system settings that drive government investment behaviours (2018/1393 refers).

3. In response, joint Ministers asked the Treasury to report back on the effectiveness of the existing capital system settings in the DHB sector, including the capital charge and depreciation funding, and evaluate any alternative options for ensuring efficient and sustainable use of capital in that sector.

4. At that time there were topical concerns about the pressure of capital charges on DHB baselines (and management practices), and the condition of some property at Middlemore Hospital (Counties-Manukau DHB) and in other DHBs. These have contributed to increases in the aggregate level of DHB deficits over the last three years.[1]

5. Since June 2018 the Government's Health and Disability System Review has started work on identifying opportunities to improve the performance, structure, and sustainability of the broad Health and Disability system with a goal of achieving equity of outcomes, and contributing to wellness for all, particularly Māori and Pacific peoples.

6. Within that broad system context there have been several positive developments in the last 6 months that will improve the way the DHB sector manages its capital resources and delivers health and disability services (T2018/1968 and T2018/3226 refer). These include:

   a A decision by Joint Ministers to reallocate $5 million from the Health capital envelope to an asset management improvement programme led by the Ministry of Health.

   b Agreement in principle from the Minister of Health to establish a new Health infrastructure planning and delivery function within the Ministry of Health.

   c An in-depth assessment by the Treasury for the Director-General of Health of current and required investment management capabilities in the Ministry of Health itself.

[1] Deficit support is available to DHBs in the form of cash injections that restore taxpayers' funds, subject to certain conditions. DHBs are required to use up any cash greater than current year depreciation and to call on shared banking borrowing limits prior to drawing upon deficit support.

Approach to this report

7. While the changes listed above are positive, we see these as necessary but not sufficient changes to capital settings in the DHB sector as none of them directly addresses the institutional arrangements that drive capital management behaviour in the DHB sector.

8. These institutional arrangements – between the government, the ministry and individual DHBs - have a profound impact on how we manage scarce capital resources in the sector. They are also within the scope of the Review to consider.

9. We consider that the presenting issues with assets and investments are symptoms of deeper issues with capital settings in the sector – ie the way current processes, rules, capabilities, incentives and information requirements affect the behaviour of parties in the DHB sector.

10. We have taken a strategic approach to joint Ministers' request to report back on the effectiveness of the existing capital system settings in the DHB sector:

    a We looked at the main features of the current system settings (eg capital charge rules and practices) and the current issues facing the DHBs.

    b We formed a view about what we need the capital settings to provide in future (objectives).

    c We then considered the interplay between the main features of the current system and the objectives of any future investment management system in the DHB sector.

11. We developed this report drawing on insights from our work on aspects of the Ministry of Health's capability and performance in relation to DHB facilities-enabled investments and Ministry-led investments[2]. We also used insights from previous work coordinated by the Ministry on capital affordability issues, and from other material in the public domain.

12. We have also had the benefit of preliminary discussions with the Review led by Heather Simpson. [34]
    [34]
    [34]
    [34] .

Analysis

Objectives of system settings

13. As a first step toward evaluating current and potential future system settings we suggest there is a need to reconsider the overall objectives of the system settings – what are we trying to achieve through the system settings?

14. In broad terms we think these objectives should be to:

    a increase **effectiveness** - by identifying and delivering the right investments and fit for purpose assets in relation to required service levels

[2] These explore the Ministry's role in the investment management system and potential establishment of a Health Infrastructure Unit.

b increase **efficiency** - by delivering the required investments at the lowest whole life cost, and delivering the required level of asset performance (ie condition, availability, utilisation, unit cost)

c increase **sustainability** - by delivering affordable health services over time, and operating a fair financial and performance playing field across DHBs

d increase **resilience** - by anticipating, responding to and coping with adverse shocks, and

e improve **adaptability** - by managing or responding to significant long term trends using transparent information feedback loops between DHBs and the Ministry. [3]

[33]

18. The analysis suggests that the system objectives are best achieved through a package of changes in capital settings, rather than by any single option. At this early stage it appears that best option would incorporate:

a a different approach to funding the additional capital costs of large-scale investments in the DHB network than simply relying on the current PBFF approach to address cost pressures associated with such investments

b a step change in the Ministry's capability to fulfil its various investment management roles in the sector, and

c a change in the way investment decision rights are applied - to both support network planning and incentivise sound asset management practices in DHBs.

[3] The objectives are adapted from the performance indicator framework used in Treasury's Investment Statement 2018.

19. If Ministers agree, we intend to further evaluate the merits, costs and risks of these types of choices with the Review over coming months.

Capital charge and depreciation funding

20. In the DHB sector (like many other government sectors) there are constraints on access to capital (and operating) funding. That means there is an ongoing challenge to address immediate service and cost pressures (and a range of capability gaps that could affect the sustainability of health services), within constrained baselines.

21. In these circumstances it makes sense to retain some mechanism for ensuring capital is used well and for keeping a focus on the efficient use of taxpayers' funds in the face of powerful incentives in favour of service delivery. In the absence of strong system stewardship capability the capital charge reminds managers that capital is not a free good and that they need to manage the full array of costs incurred to deliver health and disability services.

22. Compared with departments, the capital charge regime does bite in the DHB sector. It actually creates a fiscal pressure when DHBs secure new equity injections. This pressure – on top of other cost pressures - has led some stakeholders to argue for removal of the capital charge altogether or at least a reduction in the capital charge rate.

23. Step changes in the level of capital investments also tend to have depreciation implications that can also lead to baseline cost pressure – relative to previous levels of depreciation expenditure and anticipated levels of PBFF revenue. There is a concern that so called "depreciation funding" (the annual, internal allocation of revenue to meet depreciation costs) and cash on the balance sheet is being diverted to address other operating cost pressures. The inevitable consequence of diverting funds is that assets are run down or not replaced at the right time. Eventually this affects the viability of services.

24. Even though some stakeholders such as the Association of Salaried Medical Specialists and the Office of the Auditor-General have expressed frustration with these aspects of system settings, we consider the proposed prescription – to remove the capital charge or sequester depreciation funding - is not appropriate – at least under the current decentralised model.

25. It appears that issues attributed to depreciation or capital charge are more a reflection of the way DHB capital is managed and monitored. That raises questions about the way the system is governed just as much as the way individual DHBs are governed.

26. We think a single point response to these concerns – such as removal of capital charges altogether - is unlikely to be an effective way of addressing a whole array of system issues. We think the appropriate system settings response would involve a package of interventions: to improve capability, bring a renewed focus to what's needed from a service and network perspective (long term planning) and install more effective capital management incentives on DHB managers and Boards.

Implementation of any changes

Near term changes

27. In many respects, the capital charge operates the same way in the DHB context as it does for departments. Annex 2 shows the extent of alignment between the way the capital charge regime operates in departments and in the DHB sector.

28. Annex 2 highlights the opportunity to bring the capital charge regime into line with what happens when government invests new capital into departments to secure a change in service levels. In those cases government funds the extra capital charge costs associated with capital injections where the purpose of the capital injection is to enhance levels of service.

29. For example when government injects new capital into the Ministry of Education to expand the schools network it also acknowledges the need to fund the associated increase in capital charge expenses. The alternative (expecting the extra capital charge to be met from existing baselines) would likely undermine the original investment objectives.

30. We consider that aligning the capital charge regime with what occurs in departments is a better course of action than eliminating capital charge altogether. It provides planning stability for those DHBs who are likely to draw down capital injections. It also buys time until there is clarity over any broader institutional arrangements arising from the Review.

31. Accordingly, we recommend Ministers agree to retain the capital charge regime but modify it to allow DHBs to be directly funded for the extra capital charge expenses associated with new capital injections related to approved investments in DHB assets. This change in policy would not apply to any capital injections for DHB deficit support ie capital injections for deficit support would continue to be subject to capital charge and the extra capital charge expense would continue to be funded from baselines.

32. This represents a significant change in policy from the current position in which individual DHBs have to bear the extra costs of capital charge expense associated with new investment-related capital injections through their share of the population-based funding formula (PBFF).

33. That change will alleviate some immediate cost pressures on some DHBs and bring the policy and practice into line with current practice in government departments when capital injections result in an increase in the level of service (and hence costs of services provided).

34. This change in policy will reduce the sense of frustration in the DHB sector associated with the capital charge regime. It will bring some planning certainty for Canterbury, West Coast and Southern DHBs, who are facing a significant increase in capital charge expenses from 2019/20. It will also sharpen the focus on operational financial performance ie the operational result before capital charge expenses.

35. However, the proposed change in policy will be forward facing, not retrospective. As such it won't compensate DHBs for the capital charge expenses associated with the past drawdown of capital injections, such as occurred at Capital Coast Health some years ago.

Immediate fiscal implications

36. The fiscal effects of this change in policy are currently being considered in Budget 2019. If Budget Ministers agree, this change in policy can take effect immediately ie for new capital charge expenses that will be incurred from 2019/20 as and when capital injections are drawn down.

37. The estimated ongoing cost of this policy change for Budget 19 is [33] in the first year due to the timing of equity injections). While funding new capital charge expenses directly would have an impact on the operating allowance in Budget 19, there would be a (partially) offsetting impact on the capital allowance due to a lower deficit support requirement for the sector.

38. The primary beneficiaries of this policy change in Budget 19 would be the Canterbury and West Coast DHBs due to the significant new assets that will be transferred from the Crown to these DHBs in 2019 (Christchurch Acute Services Block, Grey Hospital). It would also impact other DHBs drawing down equity in relation to previously approved business cases (eg, Auckland DHB Facilities Infrastructure Remediation Programme – tranche 1, Counties Manukau DHB Mental Health Inpatient Unit)

Medium term changes

39. There is a wide range of choices that, to varying degrees, would achieve the objectives of system settings. [33]
[33]

40. [33]

41. We consider the Review provides the best forum for determining the right mix of future capital settings and the timing of any changes in policy. This is due to provide an interim report by July 2019 and a final report by 31 March 2020.

42. To that end we intend to work closely with the Review in coming months. We hope that work will enable stakeholders to consider what the future array of system settings should be and how to get there. The sooner that can be achieved the greater the planning certainty for all stakeholders.

Next Steps

43. The Treasury has developed a constructive relationship with the Review Chair and the secretariat. We are currently working with the Review secretariat to scope a joint initiative looking at fit-for-purpose capital system settings in a future health system, and we seek joint Minister support for this co-development approach.

44. We anticipate working closely with the Ministry in this exercise given their current work underway to lift the capability in the Ministry and across the DHB sector.

[4] For example, the current joint Minister approval threshold of $10 million for buildings is lower than the equivalent Cabinet approval threshold for departments $25 million whole of life cost threshold.

[33]

Annex 2: Alignment of capital charge policy and practice in DHB sector and in Departments

	Features of Capital Charge regime as it applies in different sectors		
	in Departments	in DHB sector	in DHB sector
	Status quo	Status quo	Proposed change
Methodology			
Capital charge rate (6% currently)	✓	✓	✓
Applied to agency taxpayers' funds balance at 31 December and 30 June each year	✓	✓	✓
Calculation cycle: 6 monthly, in arrears	✓	✓	✓
Administration of the regime			
Capital charge calculated by:	Treasury	Ministry of Health	Ministry of Health
Invoicing cycle: 6 monthly	✓	✓	✓
Funding policy relating to capital injections			
For investment in agency fixed assets to provide uplift in level of service	Increase in revenue	No change in revenue	Increase in revenue
For deficit support/working capital/no uplift in level of service	No change in revenue	No change in revenue	No change in revenue
Impact of capital charge funding on operating allowance	✓	N/A	✓
Financial incentive associated with voluntary return of capital			
Reduction in capital charge expense without corresponding reduction in revenue	✓	✓	✓