The Treasury

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Release Document

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Net Zero Capital Allowances

Date:	4 April 2011	Report No:	T2011/691

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Agree** to include net zero capital allowances in the Budget 2011 fiscal forecasts and the Fiscal Strategy Report **Indicate** whether you want to lower the amount of 'gross' new capital investment in future Budgets	Read before Fiscal Issues at 3:30pm on: Wednesday 6 April 2011

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Richard Downing	Senior Analyst, Fiscal Management	[1]	

Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

Treasury Report: Net Zero Capital Allowances

Purpose of Report

1. This report provides you with Treasury's advice on including net zero capital allowances in the fiscal strategy and fiscal forecasts for Budget 2011, including:

   - the feasibility of net zero capital allowances and how this would be included in the fiscal strategy and forecasts;
   - the amount of new capital investment you want to signal for future Budgets;
   - driving efficiency and policy change as part of the balance sheet strategy; and
   - further work on improving capital allocation processes.

Net Zero Capital Allowances in the Fiscal Strategy

Including a net zero capital allowance in the fiscal strategy

2. The fiscal strategy for Budget 2011 targets a return to surplus in 2013/14. Factoring in changes to the operating allowance and savings in Budget 2011, achieving this target will require introducing a net zero capital allowance in Budgets 2012, 2013 and 2014.

3. A net zero capital allowance would mean that new capital spending would be offset by funding from the Crown balance sheet. The current fiscal strategy, as signalled in the Budget Policy Statement, incorporates gross capital investment of $1.39 billion per annum across the forecast period. Based on Treasury's early estimate of $5-7 billion of proceeds from the Mixed Ownership Model, the capital released would be sufficient to offset new capital spending over the forecast period.

4. The Cabinet paper on mixed ownership makes it clear that the Government will only proceed if the Government's tests are met, and is subject to detailed scoping studies and market conditions. It is possible that for these or some other reason, the Mixed Ownership Model may not proceed as anticipated. Incorporating three net zero capital Budgets into the fiscal strategy does expose the Government to some risk of that scenario. The main options at that stage would be:

   - revising the fiscal strategy by increasing net capital allowances, to reflect the fact that mixed ownership proceeds were not achievable; or
   - retaining the fiscal strategy, and look for alternative ways to achieve net zero budgets, through a combination of other sources of capital to release and/or lower gross capital expenditure.

Including net zero in the fiscal forecasts

5. If Cabinet agrees to the Mixed Ownership Model policy, the fiscal forecasts in the Budget and Economic Fiscal Update (BEFU) will incorporate a lower debt track that will result from funding future capital investment from elsewhere in the Crown balance sheet, including Mixed Ownership proceeds.

6. The BEFU forecasts will include a signal of the level of gross new capital spending per year in Budgets 2012, 2013 and 2014, depending on your response to recommendation b. This is important from a fiscal impulse point of view as it signals that the Crown will be making capital investment in the future. However, new capital investment will be offset by a line in the forecast fiscal statements showing that the funding will be sourced from the balance sheet. The line would not specifically show the anticipated revenue from Mixed Ownership.

Signalling the amount of gross capital investment

7. Introducing net zero capital allowances across three years will contribute to achieving your fiscal strategy. The current fiscal strategy, as per the Budget Policy Statement, signals gross new capital investment of $1.39 billion in each of those Budgets. We recommend that as well as announcing net zero capital allowances, you signal a lower level of 'gross' capital spending in future Budgets.

8. Based on our assessment of the capital intentions surveys in 2010, gross capital investment of $900 million in each of Budgets 2012, 2013 and 2014 would be feasible. However, this would involve further trade-offs across investment priorities and is likely to require changes to current policy settings, operating models and service levels. ECC has invited selected capital-intensive agencies to reveal more cost-effective strategic choices in the period from May to July this year.

9. Lowering the amount of gross capital investment would send a signal to agencies that the Government expects to see efficiency gains from the balance sheet and reconsideration of existing business models. This would be consistent with the approach taken on operating spending and ensuring that agencies continue to explore ways to better use their balance sheets.

10. A lower amount of gross capital investment would also result in less of the Mixed Ownership proceeds being directed toward new capital investment. This would give you flexibility in the future to extend net zero capital allowances past the current forecast period or to further reduce debt and restore the buffer against future possible shocks.

Balance Sheet Strategy

Driving efficiency and policy change through capital investment

11. The Crown's overall balance sheet is expected to grow by $36 billion over the next four years. Despite this growth, the Government faces significant pressure from agencies for new capital investment in social assets driven by current policy settings. Our advice on the balance sheet strategy (T2010/1668) suggests that for social assets:

    - a smaller portfolio over time is likely to be beneficial;
    - there is scope for changes in the composition, efficiency and performance to support the Government's aim of better public services for less; and
    - a focus on managing demand, efficiency and changes to policy and operational settings would reduce the need for capital investment.

12. These factors indicate that there is considerable scope to use the allocation of new capital investment to drive and support more sustainable and affordable service models. Lowering the amount of new capital investment in future Budgets is one lever available to drive efficiency and reconsideration of existing business models. This would involve a greater focus on moving capital investment away from supporting

current standards/models to a more transformative focus as signalled in the Investment Statement.

Demand for new capital investment

13. The need for policy change in capital intensive agencies is supported by closer inspection of their aggregate capital intentions. **[2]** based on continuation of current policy settings, plus demographic and inflation assumptions.

14. The estimate of unfunded capital expenditure is subject to a high level of uncertainty across the three years. It is based on agency views of when they think investment decisions need to be made. The actual level of unfunded capital will be influenced by various factors including the timing and quality of business cases seeking funding and whether Ministers elect to prioritise capital projects from within existing baselines.

15. However, the aggregate intentions illustrate that current policy settings are unaffordable and changes will be required to policy settings, operating models and services, especially if you signal gross capital investment of $900 million in future Budgets. Signalling lower gross new capital investment in future Budgets would challenge agencies to develop and reveal strategic choices that could close the affordability gap and at the same time underpin cost effective service delivery.

16. In our view, an allowance of $900 million for new capital investment would be possible. However, achieving such a level of gross investment, even if offset by other revenue sources, will require the Government to make trade-offs across different priority areas. For example, these choices would most likely involve:

[2]

17. A $900 million allowance would be manageable based on the above assumptions and allows a small provision for other capital pressures such as the KiwiRail turnaround plan. It makes no allowance for other priorities that may emerge between now and future Budgets.

Other possible sources across the balance sheet

18. As well as the demand for new capital investment, exploring other possible parts of the Crown balance sheet to improve efficiency or reprioritise across agencies' balance sheets will be important.

19. Treasury is examining other parts of the Crown balance sheet where commercial arrangements could be considered that would introduce private sector disciplines and/or release capital for higher priority uses. At this stage we are developing advice on the viability of these options and the amount of capital that would likely be freed up

by altering these commercial arrangements. Treasury will provide advice on these options in the coming weeks.

20. We are also looking at two possibilities that would free up funding from agencies balance sheets:

[2]

21.

Next steps: managing capital intentions and further exploring the balance sheet

22. You have signalled that as part of the Government's focus on the balance sheet, changes to the capital allocation process in future Budgets are needed to improve overall capital decision making. After Budget 2011, Treasury will need to consider options for shifting the Budget capital process away from focusing on the increment of new capital and toward an entire balance sheet focus. Areas that we plan to examine further are:

- bringing together the investment statement, the 10-year capital intentions and the capital part of the budget process into an integrated process that starts with the balance sheet;

- further exploring other possible commercial arrangements across the balance sheet to fund new capital investment;

[2]

- further work will need to be done on the scalability of capital projects set out in agencies capital intentions and identifying changes to policy settings in sectors that would reduce the demand for capital investment by agencies.

23. Any such work will need to link into wider work on approaches to better budget management. This includes continuing to refocus the Budget process on exploring baseline expenditure as well new spending. Treasury will provide further advice on how the Budget capital process can be improved after Budget 2011.

Recommended Action

We recommend that you:

a **agree** to include net zero capital allowances for Budgets 2012, 2013 and 2014 in the Budget 2011 fiscal forecasts and the Fiscal Strategy Report contingent on the outcome of Cabinet decisions on the Mixed Ownership Model paper on April 11; and

Agree/disagree

b **indicate** whether you want to announce/state in the Fiscal Strategy Report a lower level of 'gross' new capital investment of $900 million in Budgets 2012, 2013 and 2014.

Agree/disagree

Richard Downing
Senior Analyst, Fiscal Management
for Secretary to the Treasury

Hon Bill English
Minister of Finance