TE TAI ŌHANGA
THE TREASURY

Reference: 20220471

30 November 2022

[redacted]

Dear [redacted]

Thank you for your Official Information Act request, received on 2 November 2022. You requested:

> *I have found reference on the Treasury's website to a report, T2020/1249 "Report back on the capital charge regime," of which I would appreciate a copy. Is this the report that the Hon Chris Hipkins was referring to? If not, have you received other reports from the Treasury on the capital charge? If so, I would also appreciate copies of those reports.*

I am aware you also made the same request to the Minister of Finance, who referred you to this response.

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	31 March 2021	T2021/803: District Health Boards – Drawdown from Contingency Funding for Capital Charge and Tranche 2 Equity Support	Release in part
2.	31 March 2021	T2021/727: Developments Regarding Capital Charge in the Health Sector	Release in full
3.	29 June 2020	T2020/1249: Report back on the Capital Charge Regime	Release in full
4.	28 November 2019	T2019/3480: Public Sector Discount Rate and Capital Charge	Release in full
5.	28 February 2019	T2019/354: Capital system settings in DHB sector	Release in part

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https://treasury.govt.nz

I have decided to release the relevant parts of the documents listed above, subject to information being withheld under the following section of the Official Information Act, as applicable:

- names and contact details of officials, under section 9(2)(g)(ii) – to maintain the effective conduct of public affairs through protecting Ministers, members of government organisations, officers and employees from improper pressure or harassment,
- certain sensitive advice, under section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions,
- direct dial phone numbers of officials, under section 9(2)(k) – to prevent the disclosure of information for improper gain or improper advantage.

Direct dial phone numbers of officials have been redacted under section 9(2)(k) in order to reduce the possibility of staff being exposed to phishing and other scams. This is because information released under the OIA may end up in the public domain, for example, on websites including Treasury's website.

Some information has been redacted because it is not covered by the scope of your request. This is because the documents include matters outside your specific request.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This reply addresses the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Jess Hewat
Manager, Health and ACC

TOIA 20220471
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THE TREASURY

MINISTRY OF HEALTH
MANATŪ HAUORA

Joint Briefing

District Health Boards – Drawdown from Contingency Funding for Capital Charge and Tranche 2 Equity Support

Date due to MO:	31 March 2021	**Action required by:**	9 April 2021
Security level:		**Health Report:**	20210647
		Treasury Report:	2021/803
To:	Hon Andrew Little, Minister of Health		
	Hon Grant Robertson, Minister of Finance		

Contact for telephone discussion

Name	Position	Telephone
Kevin Davies	Deputy Chief Financial Officer, Corporate Services. Ministry of Health	s9(2)(g)(ii) [redacted]
Jess Hewat	Manager, Health, The Treasury	

Minister's office to complete:

☐ Approved ☐ Decline ☐ Noted

☐ Needs change ☐ Seen ☐ Overtaken by events

☐ See Minister's Notes ☐ Withdrawn

Comment:

MINISTRY OF HEALTH
MANATŪ HAUORA

District Health Boards – Drawdown from Contingency Funding for Capital Charge and Tranche 2 Equity Support

Security level:		**Date:**	31 March 2021
To:	Hon Andrew Little, Minister of Health Hon Grant Robertson, Minister of Finance		

Purpose of report

1. This report seeks approval from the Minister of Health and the Minister of Finance to drawdown contingency funding of:

   a. $66.643 million over four years from the "*District Health Boards – Capital Charge Contingency*" to fund increases in capital charge payable by the Canterbury and West Coast District Health Boards (DHBs) resulting from new capital projects; and

   Out of scope

Summary

Capital Charge Relief Drawdowns

2. In Budget 2019, Cabinet approved the establishment of a tagged operating contingency, titled "District Health Boards – Capital Charge Contingency", totalling $197 million over four years, with $32 million in 2019/20 and $55 million per annum on-going thereafter. This contingency is to provide additional funding to cover the increase in capital charge associated with new Crown investments [CAB-19-MIN-0174.19 refers].

3. The Ministry proposes to drawdown $66.643 million over four years from the contingency funding as follows:

   a. Canterbury DHB – $6.916 million for 2020/21 and $13.833 million per year thereafter to be allocated to address increased capital charge payable relating to the transfer of Waipapa (previously referred to as the Christchurch Hospital Hagley Building) to Canterbury DHB.

   b. West Coast DHB – $2.604 million for 2020/21 and $5.208 million per year thereafter to be allocated to address increased capital charge payable relating to the transfer of Te Nikau Hospital to the West Coast DHB.

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Out of scope

[redacted]

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Recommendations

We recommend you:

	Minister of Health	Minister of Finance
a) **Note** the establishment of the tagged operating contingency totalling $197 million over four years in Budget 2019 for increases in DHBs capital charge [CAB-19-MIN-0174.19 refers].		
b) **Note** that joint Ministers have been authorised to draw down the tagged contingency funding referred in a) above, in line with increases in capital charge payable by DHBs.		
c) **Approve** the following changes to the DHB – Capital Charge contingency:	**Yes/No**	**Yes/No**

	2020/21	2021/22	2022/23	2023/24 & Outyears
District Health Boards – Capital Charge Contingency	**55.000**	**55.000**	**55.000**	**55.000**
Canterbury DHB	6.916	13.833	13.833	13.833
West Coast DHB	2.604	5.208	5.208	5.208
Total Contingency Drawdown	**9.520**	**19.041**	**19.041**	**19.041**
Contingency Remaining	**45.480**	**35.959**	**35.959**	**35.959**

Out of scope

[redacted]

Minister of Health | Minister of Finance

Out of scope

[redacted]

21.03.2021

Robyn Shearer
Deputy Chief Executive
DHB Performance and Support

Jess Hewat
Manager, Health
The Treasury

Hon Andrew Little
Minister of Health
Date:

Hon Grant Robertson
Minister of Finance
Date:

District Health Boards – Drawdown from Contingency Funding for Capital Charge and Tranche 2 Equity Support

Context

10. Capital charge is calculated and invoiced by the Ministry to the DHBs twice a year; once on DHBs 31 December net asset balances (taxpayer funds) and then again on their audited 30 June net asset balances. The rate used for calculation of capital charge is the public sector discount rate, which currently sits at 5%.

11. In Budget 2019, Cabinet approved the establishment of a tagged operating contingency, "District Health Boards – Capital Charge Contingency", totalling $197 million over four years, with $32 million in 2019/20 and $55 million per annum on going thereafter, to cover increases in DHBs capital charge from 2019 onwards [CAB-19-MIN-0174.19 refers]. There have been no capital charge relief drawdowns to date.

12. Out of scope

13.

Capital Charge Contingency

Background

14. In Budget 2019, Cabinet approved the establishment of a tagged operating contingency, titled "District Health Boards – Capital Charge Contingency", totalling $197 million over four years, with $32 million in 2019/20 and $55 million per annum on going thereafter, for increases in DHBs capital charge [CAB-19-MIN-0174.19 refers].

15. This contingency was set up to provide additional funding to DHBs where capital charge costs were increased due to capital contributions for new investments, and the Minister of Finance and Minister of Health were jointly authorised to drawdown on the contingency.

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16. Capital charge is calculated and invoiced by the Ministry to the DHBs twice a year; once on DHBs 31 December net asset balances (taxpayer funds) and then again on their audited 30 June net asset balances. The rate used for calculation of capital charge is the public sector discount rate, which currently sits at 5%.

17. A reduction in net assets due to the occurrence of a deficit will result in the reduction of capital charge payable.

18. We are now seeking to draw down from the contingency for Canterbury and West Coast DHBs' associated capital charge increases.

Calculation

19. This is the first instance of a drawdown on this contingency. A combination of DHB deficits and low value drawdowns for the Health Capital Envelope has meant that there has been no requirement for additional capital charge relief to be allocated to any DHBs meaning there was no drawdown on the $32 million in 2019/20.

20. However, there are now two DHBs – Canterbury and West Coast - who have had assets transferred to them from the Health Capital Envelope that have had a material effect upon their net assets, with associated increases to capital charge payable:

   a. Canterbury DHB has incurred an increased capital charge payable due to the transfer from the Crown of Waipapa (formerly known as the Christchurch Hospital Hagley Facility). This transfer occurred on 1 November 2020 and was agreed by the Ministers of Health and Finance in June 2020 (HR 20200276 / T2020/922 refers).

   b. West Coast DHB has incurred an increased capital charge payable due to the transfer from the Crown of the Te Nikau Grey Base Hospital and Health Centre. This transfer occurred on 1 August 2020 and was agreed by the Ministers of Health and Finance in June 2020 (HR 20200277 / T2020/1541 refers).

21. Both DHBs financial performance during the prior 12 months leading up to the transfer of the asset resulted in a deficit. Therefore, the amount of capital charge relief funding that will be given to the DHBs has been reduced by the size of the deficit in the prior 12-month period. The table below shows the calculation of the relief to be provided:

Table 1: Calculation of Capital Charge Relief Funding

$m		CDHB		WCDHB	
Period	Ref	20/21	21/22 onwards	20/21	21/22 onwards
Capital Injection	A	541.464		120.948	
Surplus / (Deficit) for the prior twelve-month period	B	(264.810)		(16.792)	
Eligible for Capital Charge Relief	A+B=C	276.654		104.156	
Capital Charge Rate	D	5%		5%	
Capital Charge Relief	C*D	6.916	13.833	2.604	5.208

22. As indicated in Table 1, as both assets were transferred mid-financial year to their respective DHBs, the capital charge increase in the 2020/21 financial year will only be for 6 months. Thus, the capital charge relief funding allocated to the DHBs in the 2020/21 financial year has been prorated to align with the increased capital charge payable to the Crown.

Out of scope

[redacted]

Out of scope

[redacted]

Out of scope

Out of scope

[redacted]

Treasury Comment

41. The Treasury supports the requested drawdowns from the capital charge contingency. We are aware that some DHBs have not properly understood the capital charge relief policy and that the Ministry is working to clarify this for DHBs. We consider this important to ensure that DHBs are able to plan appropriately for capital charge costs and relief. The Treasury will shortly provide an Aide Memoire providing some further context.

Out of scope

[redacted]

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Out of scope

[redacted]

IN-CONFIDENCE

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Public Sector Discount Rate and Capital Charge

Date:	28 November 2019	**Report No:**	T2019/3480
		File Number:	ST-2-4-2-6

Action sought

	Action sought	**Deadline**
Hon Grant Robertson **Minister of Finance**	**Direct** the Treasury to report back on the capital charge regime in 2020 **Agree** to discuss ways of ensuring the PSDR and capital charge regimes contribute to achieving the Government's broader objectives	Thursday 5 December 2019

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
Kerry Hollingsworth	Principal Advisor, Investment Management and Asset Performance (IMAP)	s9(2)(k)	N/A (mob)	✓
Craig Murphy	Manager, Investment Management and Asset Performance (IMAP)	s9(2)(k)	s9(2)(g)(ii)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Subject to the Minister's agreement, **refer** this report to Hon Chris Hipkins, Minister of State Services, and your Associate Finance Ministers, Hon David Clark, Hon David Parker, Hon Shane Jones and Hon James Shaw, for their information and comments.

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Treasury Report: Public Sector Discount Rate and Capital Charge

Purpose of this report

1. The purpose of this report is to help resolve Ministerial questions and concerns about the level of the Public Sector Discount Rate (PSDR) and the Capital Charge rate and gain agreement on what further work, if any, is required.

2. The report has been prepared in response to a first (“discovery”) phase of a work programme that was agreed in late August 2019 (T2019/2663 refers).

3. The discovery phase centred on 10 questions we agreed with your Office relating to those concerns. These questions ranged from why we have these two elements in the public finance system, to how we arrive at the rates, how they work in practice and what further work needs to be done to resolve any residual concerns.

4. The 10 questions and our responses are set out in Annex 1 of this report. We have also prepared a Quick Guide (see Annex 2) for general audiences that sets out the basic facts about these two regimes.

5. In this report we take a step back from those detailed questions and responses and look at them through a system stewardship lens. We would like to ensure that any follow up action is properly targeted and proportionate, given other work underway to lift the effectiveness of the public finance system.

Discussion and Analysis

What systems do we have in place to help steward Crown capital resources over time?

6. The public finance system comprises a mix of statutory requirements, processes, rules, information, practices and capability, the purpose of which is to help ensure Government both achieve its objectives and meet its obligations.

7. The PSDR and capital charge regimes operate in that context. Their common purpose is to ensure that decision makers and agency managers treat capital as a valuable resource (rather than a free good) by taking account of the Crown’s cost of capital in their decisions and actions.

8. These regimes contribute to the Government’s wellbeing objectives by supporting the fiscal strategy, supporting transparency and accountability for how money is spent, and promoting good stewardship of Crown resources over time.

Have we got the right price on the Crown’s capital resources?

9. There appear to be general concerns amongst your colleagues about the level of the PSDR which appears high in the context of:

   - the recent fall in the Official Cash Rate (OCR), and reductions in the Crown’s long-term borrowing rates, and

   - equivalent rates used in some overseas jurisdictions.

10. The level of the (default) PSDR is higher than many expect. It currently stands at 6% pa. There have been questions about the level of the PSDR for some years and these may have been exacerbated by the fact there has been no evident change in the PSDR even though the Crown's borrowing costs have fallen sharply in recent months.

11. Conceptually, public sector discount rates reflect how governments value outcomes that occur in the future relative to those that occur in the present. The discount rate can be interpreted as the minimum rate of return that the government expects from its investments.

12. There is a vast economic literature on this subject that does not come to any definite conclusion. There is no completely objective way of determining public sector discount rates: value judgements and assumptions are necessary.

13. Government has had a PSDR since the 1970s. The social opportunity cost approach (SOC) is used to derive the Crown's cost of capital. This approach tries to identify the rate of return on the next best alternative to a public project. To do so it uses the long-run average return on private projects as a proxy for the opportunity cost to the Crown of using tax revenue to finance equally risky government projects. It also uses the Crown's 10-year bond rate as the proxy for the risk free borrowing rate.

14. The Treasury has twice reviewed the fitness for purpose of the current approach in the last decade, most recently in 2017. That work included consideration of the Social Rate of Time Preference (SRTP) approach, which tries to reflect the preferences of a decision-maker acting on behalf of society. However, the results did not produce a clear case for change and so the Treasury has continued to apply the SOC approach. The rationale for equivalent rates in overseas jurisdictions (such as those used in the UK or Australia) is not always clear. Some appear not to be based on observed values.

15. In addition to reflecting the value of outcomes over time, the PSDR sends a steady, long-term signal to decision-makers about the Crown's cost of capital. However, this phase of the work programme has highlighted scope to change the way this objective is met, that is by striking a better balance between maintaining the current rate and adjusting it appropriately for significant changes in long-term signals. At present the "smoothing" policy results in a change in the PSDR only if the annual calculation suggests a change greater than one whole percentage; that is, from 6% to 5% or 7%.

16. There is also scope to change the smoothing policy so that it is more responsive to significant changes in key inputs to the PSDR calculation, such as the risk-free rate. When allied with the latest information on the Crown's long-term borrowing rates, the effect of these two policy changes would be to reduce the default PSDR to 5% from the current level of 6%.

Have we reached the limits of our current approach to pricing Crown capital?

17. There appears to be a particular concern that the current level of the PSDR adversely affects the attractiveness of long-lived sustainability initiatives with high up-front costs and a long stream of future benefits.

18. In practice, current and planned spending levels are determined by a complex political process which involves many considerations other than the discount rate. The Government's strategic direction is one of the most important considerations in this process. In general, the discount rate is not nearly as important to the results of economic analysis as the quality of cost and benefit information. Using different discount rates does not significantly change the ranking between different projects, unless the cash flow profiles are very different.

19. In these circumstances, one practical approach is to apply the Treasury's published business case guidance and its cost benefit analysis (CBA) guidance. The business case framework considers five perspectives: strategic, economic, financial, commercial and management. High quality business cases can help decision makers see how well specific proposals support the Government's strategic direction.

20. The CBA guidance encourages agencies to do sensitivity analysis to understand the impact on the CBA results of changes in key assumptions. Sensitivity analysis can include the effects of different discount rates. The Treasury recommends that agencies use the published PSDR rates, unless a project-specific discount rate can be determined on objective grounds.

21. This approach is built into the CBAx tool agencies can use to estimate the economic impact of budget proposals. That tool shows the impact of using both 3% and 6% discount rates on the result. The business case for the Porirua Urban Renewal project also used the same range of rates to help understand the impact of different discount rates on long-dated social benefits.

22. Even though these techniques are being used in some proposals there is scope to further improve the understanding and use of sensitivity analysis in the development of proposals and in decision-making. The scope for change is illustrated by the fact that in Budget 2019, fewer than 30 of the approximately 650 initiatives used the Treasury's CBAx tool.

Is the capital charge regime unnecessarily affecting investment choices?

23. The main concern appears to about the direct cost of financing capital proposals; agencies observe that there are significantly lower costs of finance in the capital markets, compared with the capital charge that is applied to Crown capital injections.

24. In 2010, Cabinet agreed to align the capital charge rate with that of the default PSDR from 1 July 2011, and thus remove unnecessary complexity between the two rates (CAB Min (10) 41/9 refers). That decision helped provide a consistent signal about the cost of capital to both decision makers and those charged with the stewardship of Crown-funded capital resources employed in departments, District Health Boards (DHBs) and some Crown entities.

25. Even though that policy exists there can be differences in perspective between those who are promoting specific projects to meet Government priorities within certain funding parameters and those who, like the Treasury, have a system stewardship role that is designed to support the Government's fiscal strategy and financial reporting obligations. Sometimes the system perspective can constrain which projects are approved and how they are financed.

26. Differences of perspective play out in unintended ways, for example when the capital charge rate becomes the benchmark rate for property sale and lease back arrangements (this adds real and ongoing pressure on agency baselines). Some agencies are also actively exploring alternative financing options that appear cheaper than the capital charge rate but are predicated on transferring risk (and cost) to the Crown.

27. These points suggest that more needs to be done to improve the understanding of how the capital charge and broader system settings also contribute to achieving the Government's wellbeing objectives.

Is there still a place for a capital charge regime in the public finance system?

28. The main question mark about the capital charge regime is its effectiveness as an incentive on all departments, 20 DHBs and seven other Crown entities to make the best use of the capital resources for which they are responsible.

29. There are strong internal incentives on agencies to hold onto capital, for example to ensure they can finance their own investment priorities from baselines without having to seek new Crown capital injections. However, holding more assets than necessary is expensive for the Crown and taxpayers. The capital charge regime tries to balance the internal incentives by providing a financial incentive for agencies (and Ministers) to return capital to the centre. Returns of capital generate an immediate reduction in the capital charge expense agencies incur which gives them more spending power within baselines.

30. However, this incentive is weaker than it was when government introduced the regime in 1991. Various factors have contributed to this situation, including policy settings that constrain property rationalisation choices, uncertainty about future access to the capital needed to support future levels of service and the practice of funding agencies for capital charge associated with new capital injections.

31. Simply removing the capital charge regime is unlikely to improve the way capital is used, and would also reduce transparency of the full cost of delivering a service. This would affect the ability of Ministers and taxpayers to compare the true price of public sector outputs with those of the private sector and make judgements about value for money. In addition, under the Government's fiscal management approach, any decision to remove capital charges without a corresponding reduction in agency baselines would have a negative fiscal impact given that agency baselines currently bear around $2 billion per annum for capital charges.

32. Any replacement system would require enhanced scrutiny of agency asset and investment performance to achieve the same government objectives. This could be achieved through regular performance monitoring or periodic reviews (such as through the Investor Confidence Rating or Baseline Reviews). However, extra scrutiny would be resource intensive, and neither the Treasury nor monitoring agencies have the capability that would be needed to provide such enhanced scrutiny.

Next Steps

33. There are several possible next steps with this work programme, from doing nothing more at this time, to taking modest steps to improve current understanding and practice, to undertaking further in-depth analysis of these two regimes.

Focusing on quality and use of cost benefit analysis rather that the PSDR itself

34. We know from past experience with first principles reviews of the PSDR that in-depth work can consume significant time and effort and still yield inconclusive results. The same issue applies to work on assessing some of the detailed parameters of the PSDR model, particularly the asset beta for different types of projects. Resources would therefore need to be reallocated from other work priorities to resource any major programme of work on the PSDR.

35. However, some improvements to the current regime can be made without significant disruption to priorities. One of these is to change how the PSDR is "smoothed" over time. It is possible to make the PSDR more responsive to significant changes in key inputs, such as the risk-free rate, while still maintaining the integrity of the social opportunity cost approach to estimating the Crown's cost of capital.

36. The best time to make this policy change is in May 2020, after Budget 2020. This timeframe would minimise potential disruptions or inconsistencies in ministerial decision-making in Budget 2020, and avoid additional workloads on agencies while they focus on substantive policy issues. The effect of a range of rates is already available in Budget proposals where agencies have done sensitivity analysis using the CBAx tool or in their capital business cases.

37. There is a need to lift the quality and use of cost benefit analysis, to inform decision-making. Some policy objectives, particularly those focused on social and environmental outcomes, can be difficult to monetise or lack broadly accepted (proxy) values. The emphasis on the Living Standards Framework places even more importance on using CBA (and sensitivity analysis) appropriately, rigorously and transparently. The Treasury has work underway to improve these aspects of its own economic capability.

38. We are seeing a clear need to improve stakeholders' understanding of how the capital charge and broader system settings contribute to achieving the Government's objectives. The two annexes to this report provide a first step in that direction. We would like to discuss this further with you to ensure we are making the most effective use of our capability-lifting effort.

Choosing the right time to do further work on the capital charge regime

39. The Treasury is working with the Health and Disability System Review (HDSR) to explore how the capital charge regime and/or alternative measures can help ensure capital resources are well used. Rather than commissioning new work on the capital charge regime at this time, we propose to report back on the capital charge regime and insights from the HDSR work once that work is completed in around April 2020.

Recommended Action

We recommend that you:

Work programme

a **note** that the Treasury has completed the discovery phase of a work programme on the levels of the PSDR and capital charge (T2019/2663 refers)

Public sector discount rate

b **note** that the Treasury has reviewed the fitness for purpose of the social opportunity cost approach to setting the PSDR twice in the last 9 years, and that neither review produced a clear case for a change in approach

c **note** that the Treasury intends to change the PSDR rate smoothing policy in May 2020, after Budget 2020, to make it more responsive to significant changes in key inputs (such as the risk-free rate) while still providing a steady, long-term signal to decision-makers about the Crown's cost of capital

d **note** that in May 2020, assuming there is no further change to the latest risk free rate, the default PSDR would be 5%, compared with the current rate of 6%

e **note** that the Treasury's published cost benefit analysis (CBA) guidance encourages agencies to do sensitivity analysis, including the effects of different discount rates, to understand the impact on the CBA results of changes in key assumptions

Capital charge regime

f **note** that the Treasury is working with the Health and Disability System Review on capital settings in that sector, including the capital charge

g **direct** the Treasury to report back on the capital charge regime in 2020, after the Treasury has completed its work with the Health and Disability System Review

Further engagement with Ministerial stakeholders

h **refer** this report to Hon Chris Hipkins, Minister of State Services, and your Associate Finance Ministers, Hon David Clark, Hon David Parker, Hon Shane Jones and Hon James Shaw, for their information and comments, and

Refer/not referred.

i **agree** to discuss with the Treasury ways of ensuring the PSDR and capital charge regimes, and the use of cost benefit analysis, contribute to achieving the Government's broader objectives.

Agree/Disagree

Craig Murphy
Manager, Investment Management and Asset Performance

Hon Grant Robertson
Minister of Finance

Annex 1: Discovery phase: Questions and answers

This annex contains the Treasury’s responses to 10 questions set out in the discovery phase of the work programme to help resolve concerns about the level of the Public Sector Discount Rate (PSDR) and the Capital Charge rate (T2019/2663 refers).

1. The background and intent of each regime (ie PSDR and Capital Charge)

The PSDR reflects how the government values outcomes that occur in the future relative to those that occur in the present. The discount rate can be interpreted as the minimum rate of return that the government expects from its investments.

The Treasury’s current approach references the rate of return on private-sector investments with similar risk characteristics to the public project under consideration. Under this approach, the discount rate is composed of a risk-free rate of return plus a risk-based premium which varies according to the riskiness of the project. The calculated rate is therefore an estimate of the Crown’s opportunity cost of capital.

In practice the PSDR is used in cost benefit analysis (CBA) to convert future cash flows into today’s dollars to help decision makers choose between different public sector projects or decide whether to invest at all. The PSDR is the same as the capital charge rate.

The main purpose of the capital charge regime is to incentivise agencies to use capital efficiently and take the cost of capital into account when deciding whether to adopt capital vs. labour-intensive processes, whether to rent or buy, or whether to contract out or undertake work in-house.

The capital charge rate is akin to an interest rate, which government agencies pay to Treasury on Crown-provided capital. Agencies are often fully funded for the capital charge expense they incur when they get new Crown capital injections. If they subsequently return capital to the centre they benefit from lower capital charge expenses.

2. The interaction between these and other aspects of the Public Finance System

The public finance system comprises a mix of statutory requirements, processes, rules, information, practices and capability the purpose of which is to ensure Government meets its obligations and its objectives.

One of its objectives is to improve intergenerational wellbeing, another is to manage new spending within its fiscal allowances, and a third is to be transparent in what it does.

CBA, of which the PSDR is a component, is one tool for evaluating spending proposals. The results of a CBA can inform prioritisation decisions and provide the basis for assessing the impact of spending decisions. CBA is expected to feature of several processes within government including business cases for capital investments, the budget process for new initiative proposals and in regulatory impact assessments.

The PSDR is used to set the capital charge rate.

Once Government has made a decision to inject capital into a department or a DHB or a small number of other Crown entities the capital charge regime comes into play. The capital charge expense appears in an agency's financial statements. As such it serves as a reminder that the amount of capital employed in the agency needs to be well managed and that the cost of capital needs to be taken into account in baseline-funded spending and pricing decisions. Those decisions include selecting appropriate levels of service, making rent vs buy choices, and setting the level of user charges to third parties.

3. The relationship between external market indicators (for example the Official Cash Rate or OCR) and key inputs and assumptions used in the Treasury's PSDR methodology

The OCR is effectively a risk-free rate that is designed to achieve the Reserve Bank's monetary policy objectives over the short to medium term by influencing the borrowing and spending behaviour of institutions, companies and individuals.

By contrast, the PSDR is designed to send a long-term signal to government agencies and decision makers over the Crown's cost of capital. In that context the Government's long-term (10 year) bond rate provides a better proxy for the risk free rate we need to use in the PSDR calculation.

Ultimately the reason that the PSDR is higher than either the OCR or the bond rate is that Government is typically evaluating investments that carry varying degrees of risk. The PSDR enables a comparison of public sector projects with the rates of return that could be obtained on other projects with similar risk profiles.

4. How Treasury takes account of market prices/returns for debt and equity in the PSDR

The Treasury takes these factors into account in the model it uses to calculate the PSDR.

That model uses two proxies for the returns to debt and equity in order to give a steady, long-term signal to decision makers about the Crown's cost of capital.

- The proxy for the risk free rate of debt is the Government's long-term (10 year) bond rate.

- The proxy for the opportunity cost to the Crown of using tax revenue to finance expenditures is the long-run average return on sharemarket investments.

The model takes account of differences in systematic project risk, tax and inflation. That enables Treasury to calculate a default PSDR as well as different PSDR rates for types of projects, ie infrastructure, buildings and ICT projects.

5. High-level differences/similarities with similar methods and rates in the UK

The UK applies a discount rate of 3.5%, and lower (declining) rates for projects with very long lives. The UK approach is based on the 'social rate of time preference' (SRTP), which tries to reflect the preferences of a decision-maker acting on behalf of society. arrived at from theoretical considerations rather than from observed values.

In contrast with the SRTP approach, the Treasury's current 'social opportunity cost' (SOC) approach tries to identify the rate of return on the next best alternative to a public project. It uses empirical evidence on rates of return that can be achieved elsewhere in the economy. The same approach is used to derive the public sector discount rate in NSW government decision making processes.

6. *The practical implications (and limitations) of the two regimes (in promoting effective use of capital, setting fiscal allowances and strategic direction, business cases, budget processes and agency and government decision making)*

The role of CBA (which uses the PSDR) is to provide decision-makers with information about the impact of a project on the NZ economy. Ideally, decision makers would use this information, along with other considerations, such as the strategic direction of the government, to arrive at a decision. Treasury recommends agencies use CBA (and sensitivity analysis) but stops short of requiring CBA for all spending proposals. There are some practical reasons for this but the approach can mean decision makers don't always have information on the economic impacts of proposals.

Fiscal allowances (and sector fiscal envelopes) are determined with one eye on the pipeline of potential projects that could address particular needs or opportunities and the other eye on the government's fiscal strategy. In some sectors there is effective use of cost benefit analysis (for example in state highway investments) but this is not a universal feature of capital decision making in the Budget or in agency decisions.

The capital charge increases the transparency of Government accounting and influences decision-makers at the agency level. However, it is not sufficient on its own to ensure the effective use of capital. Government policy preferences and agency priorities have a significant bearing on how well capital is used in agencies.

The capital charge regime does not apply to some significant Crown entities where the capital has been built up over time from third party revenue (for example ACC and the NZ Transport agency). Neither does it apply to agencies with a commercial objective (for example Schedule 4A companies, Crown Research Institutes, or State Owned Enterprises). In those cases, the capital charge is replaced by return on investment and dividend policies.

7. *Discussion of the market hurdle rates for the general commercial market and renewables*

Many businesses use high hurdle rates that appear aspirational. They are often also intended to correct for optimism bias, which is a common problem in project analysis. Actual rates achieved are revealed through sharemarket returns to capital over time. The Treasury uses this type of empirical data in the calculation of the PSDR.

We are not aware of any significant differences between market rates of renewables and the general commercial market. The Commerce Commission tends to accept a lower cost of capital for pricing regulated services provided by Transpower and lines companies because these firms are operating under regulatory constraints that limit their ability to diversify risk.

8. *The implications of a lower or higher PSDR*

Using a lower PSDR in CBA would make more projects appear more attractive to decision makers. However, that in itself is unlikely to be decisive in decision-making: attractiveness is also driven by the extent of the fit with Government objectives. Further, even if the CBA reveals an attractive result, it may not make a difference to the achievability of the proposal as the decision maker needs to consider the agency's capability and the market capacity to deliver the project. Finally, in the overall government context, the Budget capital and operating allowances act as a constraint on the number and scale of projects that attract new Crown funding in a given period.

A higher PSDR would make fewer projects look attractive in CBA terms, but may not affect decision-making. Governments often have strategic objectives that result in different decisions than those implied solely by the results of cost benefit analysis.

9. Possible next steps to address identified issues/limitations

There are theoretical and empirical arguments for both why the PSDR might be too high as well as why it might be too low. There is a vast economic literature on the subject which does not come to any definite conclusion. There is no completely objective way of determining the PSDR: value judgements and assumptions are necessary.

The PSDR is only one of a number of factors that determine the outcome of a cost benefit analysis, and the outcome of cost benefit analysis is only one of the factors that decision-makers take into account in making a decision. The discount rate does not in itself, provide grounds for investing or not investing. It is one input into analysis to assist decision-making.

The discovery phase of the work programme has shown there is scope to change the responsiveness of the PSDR calculation to significant changes in the proxy for the Crown’s cost of debt (ie the Government’s long-term (10 year) bond rate) as well as the approach taken to smoothing rates over time. Taken together these two changes are likely to result in a lower PSDR in current economic circumstances (that is 5% compared with the current default rate of 6%).

There is also scope to assess some of the other parameters of the PSDR model, particularly the riskiness of different types of projects and the way liquidity is treated.

The capital charge regime still has a place in the public finance system, and the cost of administering it is low. However, the regime is much less influential on agency behaviour than it was when government introduced the regime in 1991. There are various reasons for this including:

- Government policy settings in some sectors that constrain the ability of agencies to free up capital and operating resources by rationalising property footprints
- Administrative policy settings that tend to fully fund the capital charge on new capital injections and require agencies to plan (and hold cash) for asset renewals, and
- A tendency of agencies to hold onto any surplus cash given uncertainty about the future levels of service and ease of access to new capital in future.

Altering the capital charge regime would involve a major change to public sector management settings at a time when other significant system shifts are underway.

There will be an opportunity to use insights from the Treasury’s current work with the Health and Disability System Review (HSDR) to explore alternative approaches to ensuring capital resources are well used. That work is due to be completed in around April 2020.

10. A recommended scope of work for Phase 2, if necessary.

The main proposals are to:

- Maintain the current PSDR regime but change the way the Treasury adjusts the PSDR rate over time (the “smoothing” policy) and enhance the guidance around when and how it may be appropriate use alternative discount rates in economic analysis.

- Maintain the current Capital Charge regime and report back in 2020 on implications for the regime based on insights from the Health and Disability System Review.

Annex 2: Quick guide to Public Sector Discount Rate and Capital Charge

Public Sector Discount Rate (PSDR)

What is the PSDR?

The PSDR is the rate of return that government decision-makers could earn on a next-best alternative to public investment. It is one piece of information used in the cost-benefit analysis (CBA) of public sector projects.

Why do we have a PSDR?

In CBA, a PSDR helps decision-makers to convert estimates of future costs and benefits into today's dollars so they can better compare different investment choices. This analytical process helps ensure government gets the most benefit for New Zealanders from money spent. The cost of making an investment is ultimately the cost of foregoing other investment opportunities that might have produced bigger benefits (that is the opportunity cost). Ideally, an investment should only proceed if it produces bigger benefits than alternatives.

Why is the PSDR currently 6%?

The PSDR is calculated using empirical data on a range of factors. The most significant factors in the calculation are the Crown's long-term (10-year) borrowing rate and the opportunity cost to the Crown of using tax revenue. Other factors include the riskiness of different types of assets (projects), and tax rates.

When the Treasury last reviewed the PSDR in May 2019 the calculation produced a raw default rate of 5.7% which the Treasury rounded up to 6%. The Treasury also calculates and publishes different discount rates for certain types of projects, that is, infrastructure, building and ICT projects. The rates vary from 4% to 7% according to the riskiness of those types of projects.

To avoid too frequent changes, and help ensure decision-making is consistent over time, the Treasury does an annual review of the PSDR after the May Budget. It reviews the empirical data (as above), reruns the calculation and considers whether the rate needs to change.

The current approach is to only change the rate up or down if the annual calculation suggests a change greater than one whole percentage point, that is from 6% to 5% or 7%. Treasury intends to change this smoothing policy to make it more responsive to long-term pricing signals.

What is the opportunity cost of the Crown using tax revenue?

The Treasury uses sharemarket returns as a proxy for the opportunity cost to the Crown of using tax revenue to finance investments. The sharemarket return reflects the endeavours of many people who have the incentive to seek out the most valuable investments. Currently there are no credible alternatives for estimating the Crown's opportunity cost of capital.

What is the impact on the PSDR calculation of changes in the Crown's long-term borrowing rate?

The 10-year government stock rate is used as the proxy for the Crown's long-term borrowing rate in the PSDR calculation. That rate has fallen from around 1.8% in May 2019 to around 1% in September 2019. This scale of change in the 10-year government stock rate would reduce the calculated cost of capital by around 0.65% to around 5% for the default PSDR.

Why is the PSDR higher than the Official Cash Rate or Government stock rate?

The expected rate of return on an investment increases with increased risk. Both the OCR and Government stock can be thought of as near riskless investments. The OCR/Government stock rate may be the relevant discount rate for riskless investments. However, public sector projects are not riskless; their risk characteristics are usually assumed to be broadly similar to those of private sector projects and the PSDR reflects that.

Do agencies have to use the PSDR in their economic analysis?

This is recommended unless an alternative project-specific discount rate can be determined on objective grounds. The Treasury also encourages agencies to test the sensitivity of different projects under different scenarios, including the impact of different discount rates. This analysis helps focus attention on the reliability of the main factors that are affecting the results.

For example, recent work on the Porirua Urban Renewal project tested the expected long-term social benefits for different options using discount rates of 3% and 6% (the default PSDR) and concluded that the results weren't very sensitive to changes in that factor compared with other factors. The CBAx tool enables agencies to analyse results using these two rates.

Would lowering the PSDR mean more projects could go ahead?

Potentially, lower discount rates improve both the net present value and the benefit cost ratio of an investment proposal. If cost benefit analysis were a major factor in decision-making and a lower discount rate were applied, then more projects would appear to enhance wellbeing. However, that doesn't necessarily mean more projects would go ahead. Several other factors come into play:

- Decisions need to be considered in the context of the Government's objectives, including its Fiscal Strategy. The Fiscal Strategy will in turn be influenced by the need for, and expected value from, capital investments.

- Cost benefit analysis (and associated sensitivity analysis) is just one among several factors considered in decisions about projects – there are also qualitative factors to be taken into account in decision-making.

- A lower PSDR doesn't significantly change the ranking between different options or projects with broadly similar cash profiles.

Does the current PSDR make very long-term projects unattractive?

Not necessarily. If the economic analysis reveals a low return on the investment then there is scope to re-evaluate the estimated costs and benefits of different options to see whether the investment objectives can be met in different ways.

Capital Charge

What is the capital charge?

The capital charge is an expense incurred by departments, DHBs and selected Crown entities. Capital charges total around $2 billion per annum. Baselines of those agencies (that is their approved funding) have been set at a level that covers the cost of capital charge expenses.

The capital charge is analogous to the dividends and interest that other Crown entities and State-owned enterprises must pay to the Crown and their bankers as the ‘price’ for the capital provided by them.

Every 6 months, the Treasury calculates and invoices agencies for the capital charge expense as follows:

> *The amount of taxpayers’ funds on each agency’s balance sheet at that point in time – (being the net amount government has invested over time in each agency, plus asset revaluations)*
>
> *multiplied by*
>
> *The capital charge rate – the ‘default’ PSDR, currently 6% per annum.*

Why do we have a capital charge regime?

This is about incentives. There is a cost to providing capital. If capital were free, agency managers would be inclined to invest too much and money could be wasted. The capital charge regime gives agency managers an incentive to steward their assets, to apply limited capital resources to the best value choices, to only seek new capital to the extent it can be put to good use, and to balance capital spending against other options for improving services.

Agencies that voluntarily return capital to the Crown get a financial benefit by having a reduction in their capital charge expense without a corresponding reduction in their baselines. Agencies can use this gain to fund other expenses.

The capital charge also improves transparency; it allows Ministers and taxpayers to compare the true price of public sector outputs with those of the private sector and make judgements about value for money.

What happens to agency baselines when the capital charge rate changes?

Agency’s baselines are adjusted up or down as part of a baseline update process whenever there is a change in the capital charge rate or if the asset base has been revalued. So there is no windfall gain (extra spending power) when the capital charge rate falls and conversely no extra cost pressure when the capital charge rate increases. The changes are fiscally neutral since the cash flows all occur within government.

Under the Government’s fiscal management approach, there would be a negative fiscal impact (that is a negative impact on the allowances) if a reduction in the capital charge rate were not matched by a reduction in baselines. The assumption is that the “windfall” gain would be used to buy external inputs or services, outside government.

How can agencies fund the capital charge for new government projects?

The general practice is to increase agency baseline funding to cover the extra cost of the capital charge associated with new capital injections if the capital is required to deliver an expanded level of service (e g more schools or schools with new functional standards).

TE TAI ŌHANGA
THE TREASURY

Reference: T2021/727 CM-1-3-28-0-6

Date: 31 March 2021

To: Minister of Finance (Hon Grant Robertson)

Deadline: None

Aide Memoire: Developments Regarding Capital Charge in the Health Sector

At the recent monthly Health Check-Up on 15 March, Ministers expressed concerns regarding the roll-out of the new capital charge regime in the health sector which may cause District Health Boards to delay progress on their projects. In response to these concerns, this Aide Memoire updates you on the new capital charge policy, and next steps as part of upcoming Health and Disability System Review (HDSR) decisions.

Background of Capital Charge

Capital charge is a fee paid by agencies, including DHBs, on equity held on their balance sheets. The capital charge rate is currently set at 5%, with payments required twice a year. In a general sense, the aim of capital charge is to provide a financial incentive to manage capital efficiently.

The Treasury is aware of ongoing concerns in the sector about a range of capital-related issues including the appropriateness of applying capital charges to DHB balance sheets. The HDSR outlined this issue, noting that the large and infrequent nature of health projects can result in sudden and significant increases in capital charge costs.

Capital Charge Relief Policy

In order to mitigate the financial pressure caused by capital charge, a new policy was agreed in 2019. Under this new policy, DHBs are funded for increases in capital charge costs resulting from equity increases caused by capital injections from the Health Capital Envelope. Because deficits count against equity, and therefore against capital charge costs, capital charge relief funding is lessened by the size of the DHB's deficit. The new policy applies only to government-funded capital assets (via the MYA Health Capital Envelope), and only to projects completed from 1 January 2019 onwards.

The capital charge relief is provided to relevant DHBs as baseline funding, so that increases in capital charge can be met on an ongoing basis. However, it should be noted that the new policy is intended to be a temporary measure until a long-term solution can be implemented under the new health capital system settings.

In agreeing to the new policy, Ministers made available $32 million in 2019/20 and $55 million per annum from 2020/21 in contingency. Capital charge relief funding is yet to be drawn down, but the Ministry is now seeking Joint Ministers' agreement to draw down $6.9 million and $2.6 million in 2020/21 for Canterbury DHB and West Coast DHB respectively, with those amounts rising to $13.8 million and $5.2 million per annum in out-years (H20210647/T2021/803 refers).

Perception that Capital Charge is Delaying Projects

The Treasury does not consider the current capital charge regime to be the cause of delays to government-funded capital projects. Likewise, for DHBs who wish to fund capital projects from their own balance sheets, the requirement to pay capital charge on the new assets should not be a deterring factor, as a DHB would be required to pay capital charge on any cash assets that they would use to deliver the project. This results from the fact that capital charge is calculated based on net closing equity, which includes cash assets.

While we do not consider capital charge to be a key factor in project delays, the Ministry of Health has acknowledged that communication to DHBs on how the new capital charge policy applies has not been clearly understood. Specifically, it appears that DHBs have misunderstood the relief funding as being one-off funding, rather than ongoing. The Ministry of Health has provided assurance that communication with DHBs and expectations regarding the new capital charge policy are to be clarified.

Next steps

In order to have better visibility of when capital charge relief will be required, the Treasury is engaging with the Ministry of Health on its forecasts of capital projects to be transferred to DHBs as capital injections.

The Treasury considers the concerns raised by DHBs to be symptoms of deeper issues with institutional and investment management settings in the sector. That is, the combination of roles, processes, rules, capabilities, incentives and information requirements that affect the behaviour and performance of parties in the health sector. Therefore, the Treasury will consider changes to the capital charge and depreciation system settings in the health sector as part of ongoing advice regarding HDSR.

James de Hamel, Analyst, Health, s9(2)(g)(ii)
Sebastian Doelle, Team Leader, Health, +s9(2)(g)(ii)

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Report back on the Capital Charge Regime

Date:	29 June 2020	**Report No:**	T2020/1249
		File Number:	ST-4-8-7

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**agree** to retain the capital charge as part of the current suite of settings in the public finance system **agree** to discuss this report in the context of actions planned or underway to improve the effectiveness of capital settings across the public finance system	Monday 6 July 2020

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Kerry Hollingsworth	Principal Advisor, Investment Management and Asset Performance team	s9(2)(k)	s9(2)(g)(ii)	✓
Paul Helm	Head of Government Finance Profession and Chief Government Accountant	s9(2)(k)	s9(2)(g)(ii)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Refer this report to the Hon Chris Hipkins, Hon David Parker, Hon Shane Jones and Hon James Shaw, and Hon Dr David Clark, for their information and comments.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Report back on the Capital Charge Regime

Executive Summary

This report provides you with further information and advice on the capital charge regime in the State Services. Following an independent appraisal of alternative approaches to the regime, this report recommends retaining the capital charge and progressing complementary investment and asset management actions.

In November 2019 you asked us to report back on the capital charge regime in April 2020 (T2019/3480 refers). We anticipated that the final report of the Health and Disability System Review (HDSR) would be available by then and that it would have recommendations for capital settings in the Health sector.

The Government released the final HDSR final report earlier this month. The final report makes no substantive recommendations relating to capital charge. It simply recommends further work on refining the capital charge and depreciation funding regimes in the Health sector to ensure that significant developments are properly accounted for without starving DHBs of capital for business as usual capital replacements.

Meantime, in response to your request, we commissioned an independent appraisal of alternatives to the capital charge regime from TDB Advisory. TDB Advisory was able to interview a range of stakeholders during the COVID-19 Level 4 lock down period.

The independent report identifies the main problems with the current capital charge regime as:

- The limited positive incentives arising from the regime. Decision-making is driven more by the scarcity of capital than the pricing of capital;
- The limited discretion managers have over the use of many major assets; and
- Issues over whether Treasury Vote Analysts and agencies understand adequately the concept and implementation of the regime.

At a high level, the independent report identifies a range of alternatives. These range from replacing the current regime, rebranding it, repairing it or refining it. Each alternative has a range of marginal costs and benefits.

The independent report suggests that if the capital charge were to be abolished, there would likely need to be greater use of administrative controls from the centre to achieve similar or better effects. It suggests that without a capital charge, there would be a greater need for periodic and systematic reviews of agencies' performance and decision-making given capital would be free for the agencies. These reviews would need to monitor agency investment and disinvestment decisions in a more intensive and intrusive manner than at present.

After weighing the marginal costs and benefits of different alternatives, the independent report considers that the Treasury should retain the capital charge regime and focus on repairing and refining it, rather than replacing or rebranding it. There are still system benefits from encouraging agencies to recognise the cost of owning assets and encouraging better management of Crown assets. Further, without the regime in place there would be little transparency of the full cost of government services. This transparency enables the cost of services in the public sector to be stated on a basis comparable with relevant services in the private sector.

The independent report suggests that repairing and refining the capital charge regime would involve better communication and education (eg on the nexus between the purposes of the regime and Government's investment objectives), more consistent application and enforcement of the regime and stronger connections with other system settings like the Investor Confidence Rating (ICR) and Baseline Reviews.

These insights are consistent with our previous observations about the strengths and limitations of the current regime. We favour retaining the capital charge as a valuable element of the public finance system. However we consider that our modernising effort is best spent on strengthening other elements of the system that are likely to be more effective in promoting good asset and investment management practice, such as improving the quality of strategic planning, improving the ICR and targeted baseline reviews, and enhancing performance reporting. We also anticipate working with the Transition Unit to refine capital settings in the Health sector.

We would appreciate the opportunity to discuss these findings and our next steps with you as soon as practicable. Meantime we invite you to share this report with selected Ministerial colleagues who may be interested in this matter.

Recommended Action

We recommend that you:

a **note** that, as requested, the Treasury commissioned independent input on alternatives to the capital charge regime from TDB Advisory, financial and economic advisors

b **note** that the independent report considers that the capital charge has a small but positive net value to the system and that Treasury should retain the capital charge regime and focus on repairing and refining it rather than replacing or rebranding it

c **agree** to retain the capital charge as part of the current suite of settings in the public finance system

~~Agree/disagree~~. Defer decisions

d **agree** to discuss this report in the context of actions planned or underway to improve the effectiveness of capital settings across the public finance system, and

~~Agree/disagree~~. Defer decisions

e **refer** this report to the Hon Chris Hipkins, Minister of State Services, your Associate Finance Ministers, Hon David Parker, Hon Shane Jones and Hon James Shaw, and the Minister of Health, Hon Dr David Clark, for their information and comments.

Refer/not referred.

Paul Helm
Head of Government Finance Profession and Chief Government Accountant

Hon Grant Robertson
Minister of Finance

Treasury Report: Report back on the Capital Charge Regime

Purpose of Report

1. This report provides advice on the future of the capital charge regime in response to your request in late 2019 for a report back on the regime in April 2020 (T2019/3480 refers). We delayed sending this report back until now given the necessary focus on COVID-19 issues.

2. The report provides a basis for discussion with you at an appropriate time, on steps that could be taken to ensure a combination of the capital charge regime and other system settings best support Government to achieve its investment intentions.

Background

3. The capital charge regime applies to all departments, all DHBs and seven other Crown entities[1]. These entities have total taxpayers' funds of nearly $40 billion[2] and incur annual capital charges of around $2.4 billion, based on the current public sector discount rate (PSDR) of 6% per annum. Recently we completed a review of the PSDR, which we intend to reduce to 5% per annum (T2020/1939 refers). As a result, the capital charge rate will also fall to 5%.

4. The capital charge regime provides a financial incentive to reduce the level of taxpayers' funds employed in these agencies. Under the current regime, agencies that voluntarily return capital to the centre gain a baseline benefit in terms of lower capital charge expenses that they can then use to cover other costs or deliver more services.

5. In November 2019, we reported that we were working with the Health and Disability System Review (HDSR) to explore how the capital charge regime and/or alternative measures can help ensure capital resources are well used. You directed us to report back on the capital charge regime and insights from the HDSR work once that work was completed in around April 2020 (T2019/3480 refers).

6. Meantime, based on your feedback on our November 2019 report we commissioned and received an independent appraisal of alternatives to the capital charge regime from TDB Advisory, a Wellington-based firm with expertise in corporate finance and economics.

7. In addition to bringing their own professional perspectives, TDB Advisory interviewed a range of stakeholders during the COVID-19 Level 4 lock down period, including the chief financial officers of four investment-intensive departments (Inland Revenue Department, NZ Defence Force, the Ministry of Education and the Ministry of Health), Treasury staff and academics.

[1] The regime applies to Crown entities whose taxpayers' funds exceed $15 million. The seven Crown entities are Health Research Council, Maritime NZ, Rescue Coordination Centre NZ, NZ Antarctic Institute, NZ Qualifications Authority, Tertiary Education Commission, NZ Trade and Enterprise. Of these seven entities, only three have an annual capital charge expense greater than $2 million.

[2] For reference purposes, this sum equals 28% of the value of assets managed by all departments and Crown entities ($140 billion), including those not subject to capital charge. Of those Crown entities not subject to the capital charge regime, Kāinga Ora and the NZ Transport Agency together manage over $66 billion worth of assets.

Health and Disability System Review

8. Government has just released the final HDSR report. It proposes a wide range of institutional and governance changes to improve the effectiveness of the health system, including the way assets and investments are managed. Cabinet has agreed to establish a Transition Unit to respond to the recommendations in the report. We anticipate working closely with the Transition Unit.

9. The recommendations include further work on refining the capital charge and depreciation funding regimes in the Health sector to ensure that significant developments are properly accounted for without starving DHBs of capital for business as usual capital replacements.

10. The HDSR report puts the capital charge concerns in context by:

- Endorsing the Government's B2019 decision to mitigate the downside of the capital charge by fully funding capital charges associated with new facilities.
- Identifying residual issues with depreciation funding, including the fact that DHB Boards have diverted funding to cover other operating expenses.
- Suggesting a new sector entity (Health NZ) would be better placed to manage volatility in funding flows associated with significant rebuilds.
- Stating that recommended changes to DHB governance should also improve investment decision making and encourage longer term thinking, locally, and.
- Calling on the health system to work collaboratively with Treasury to develop solutions to these issues.

Results of Independent Appraisal

The capital charge regime has two main objectives and some benefits…

11. The independent report identifies and affirms the two main objectives of the capital charge regime which it refers to as:

- the **incentive** objective – to ensure agencies take the cost of capital into account in decision-making, and
- the **transparency** objective – to ensure the appropriations to government agencies reflect the total cost of the agency's outputs.

12. The benefits of the regime arise from encouraging agencies to recognise the cost of owning assets and encouraging better management of their assets. Further, without the regime in place there would be little transparency over the full cost of government services. This transparency enables the cost of services in the public sector to be stated on bases comparable with those in the private sector.

13. The report states that the capital charge has been influential in encouraging agencies to dispose of/not invest in assets they have discretion over. It also says the compliance costs of the capital-charge regime appear to be relatively low and that the authors of the report did not find any significant perverse incentives arising from the regime.

14. It states that agencies generally agreed the opportunity costs of capital should be recognised in agency cost structures. Some agencies suggested that the capital charge had fulfilled its purpose – it had encouraged voluntary disposals of surplus assets and there was no longer a reason to continue it.

…but there are several problems with the regime…

15. The independent report identifies the main problems with the current capital charge regime as:

- The limited positive incentives arising from the regime. Decision-making is driven more by the scarcity of capital than the pricing of capital;
- The limited discretion agency managers have over the use of many major assets; and
- Issues over whether Treasury and agencies understand adequately the concept and implementation of the regime.

16. Some of those interviewed considered the capital charge has served its purpose and no longer incentivises effective management of their assets. The report states that there is potential for gaming the system, for example around the intra-year timing of budgeted versus actual capital spend and the associated capital charge appropriations.

17. Some agencies felt the capital charge had little or no real impact on their decision-making processes. Instead, the main driver of behaviour was the scarcity of capital available for investment.

18. The main drawback to the intended effect of the capital-charge regime appears to be around the application of the capital charge to agencies which have little control or discretion over the continued ownership and use of the assets on their balance sheets. This can be due to statutory requirements or other policy preferences that affect, for example, school land and buildings, prisons, hospitals etc. In these circumstances, the capital charge can appear an unnecessary burden or inconvenience with little compensating benefit. The report speculates that if the regime were abandoned, agencies may be inclined to revert to less efficient asset management practices.

…and several alternative approaches to the problems…

19. The independent report reveals four broad responses to the contemporary problems. At a high level the alternatives range from replacing the current regime, rebranding it, repairing it or refining it. These are shown in the figure below.

20. One category, “Replace” considers options that could replace the capital-charge regime. The other categories consider how the current capital-charge regime could be developed and strengthened. The report evaluates the marginal costs and benefits of 13 different sub-options (relative to the status quo) to determine which of these are likely to add the most value.

Figure 1: Overview of alternative approaches identified by independent review

Replace

- "Replace" considers options that involve replacing the capital charge with another mechanism to ensure the efficient use of taxpayer funds.
- Replacing would require greater use of central administrative controls including potentially giving more weight to existing Treasury mechanisms such as the investor confidence rating (ICR) or cost-benefit analysis (CBA).

Refine

- "Refine" options acknowledge the existing capital charge should continue but requires further development.
- Refinements to the existing regime could include more frequent adjustments to the rate, restricting or expanding the asset classes covered by the capital charge, or allowing agencies to negotiate their own rate.

Rebrand

- "Rebranding" refers to options that are largely cosmetic rather than substantive changes to the regime.
- Options include internal debt funding (with a related interest charge) and equity funding (with a related dividend expectation).

Repair

- "Repairing" looks at improving education and communication and achieving a more consistent application.
- The focus is on understanding how the capital-charge regime works and ensuring universal agreement on and consistent application of reporting, budgeting and appropriation requirements.

The independent report favours retaining rather than abolishing the capital charge…

21. After weighing the marginal costs and benefits of different alternatives, the independent report considers that the Treasury should retain the capital charge regime and focus on repairing and refining it rather than replacing or rebranding it.

22. The independent report states that if the capital charge were to be abolished, there would likely need to be greater use of administrative controls from the centre to achieve similar or better effects. Without a capital charge, there would be a greater need for periodic and systematic reviews of agencies' performance and decision-making. These reviews would need to monitor agency performance and in particular, their investment and disinvestment decisions in a more intensive and intrusive manner given capital would essentially be free for the agencies.

…and beefing up the current regime in several ways…

23. The independent report states that repairing and refining the capital charge regime would involve a suite of actions, as shown in the figure below.

24. The most important of these actions is better education and communication of the purposes of the capital charge regime, with a particular focus on the nexus between the regime and Government's investment objectives.

Figure 2: Specific proposals from the independent review

Better communication and education

- Build a solid foundation for Vote Analysts to consider the regime from both an agency and Treasury perspective.
- Develop better communication between the Treasury and agencies to better align incentives.

More stringent application and enforcement

- Promote more effective asset management and not just as a by-product of the scarcity of capital.
- Greater focus on identifying assets that should and should not be subject to the regime.

Strengthen ICR

- ICR easily understood by agencies for recognising efficient use of assets.
- Encourages improved governance and monitoring as participating agencies are incentivised to improve their rating.

More frequent adjustments to the rate

- A more dynamic capital-charge rate better reflects changing market conditions.
- Greater buy-in not only from agencies but also from Treasury analysts who will be monitoring changes in the rate for their respective Votes.

Discussion and Analysis

The report provides a fresh perspective on an established part of the public finance system…

25. The independent report is helpful because it evaluates at a high level, a much broader range of possible responses to the identified issues than has been done before. Previous discussions have tended to centre on a binary choice – retain or remove the capital charge – whereas the independent report has revealed other possibilities with different value propositions.

26. The report also usefully weighs up both agency and Treasury experiences and perspectives. Amongst the agency leaders surveyed there is general support for retaining the capital charge regime provided there are changes in administrative practices and better system integration.

27. Overall, the observations and insights in the report are consistent with our previous comments about the strengths and limitations of the current regime. It confirms the need for such a mechanism while reinforcing the need to improve stakeholders' understanding of how the capital charge and broader system settings contribute to achieving the Government's objectives.

…challenges Treasury to improve the way it applies the regime…

Clarify Treasury policy and practices

28. The independent report calls out some examples of inconsistencies in the way the capital charge regime is applied in practice. These relate to timing differences between drawdown of revenue (for capital charge) relative to the drawdown of capital (which triggers the capital charge expense). It suggests that Treasury should apply a more consistent approach to the capital-charge regime across all Votes.

29. We acknowledge the issue raised in the report and the potential for well-intentioned actions to undermine the integrity of the capital charge regime. This is something we intend to address through our ongoing Vote work and through the finance development programme, which operates under the auspices of the Head of Government Finance.

…and better integrate its system improvement efforts.

30. Since the capital charge regime was established in the early 1990's, Treasury has introduced several other system changes with similar purposes to the capital charge regime. Arguably, the unintended effect of introducing new elements into the system, such as the ICR, baseline reviews or different planning products, has been to emphasise differences and create further silos rather than emphasise and leverage common themes.

31. The independent report serves as a timely reminder to rethink how we communicate and engage with stakeholders on the efficient use of taxpayers' funds in support of quality government services and wellbeing outcomes for New Zealanders, as explained in the 2018 Investment Statement.

32. The remaining sections in this report explain some of the ways in which we could better integrate elements of the current system.

Better system leadership and governance

33. Most of the specific proposals identified by the review (see figure 2 above) are within Treasury's domain to address. However, it seems clear that Treasury cannot act in a unilateral way or with a singular focus on the capital charge, if it intends to improve the performance of the public finance system.

34. In addition to our agency interactions, we have been working closely with a system governance group of officials called Investment Officials. That group comprises the procurement, property, digital and data steward functional leaders, the head of government finance profession, as well as representatives from the NIU and the NZ Infrastructure Commission, Te Waihanga.

35. We intend to use that forum, and other officials groups, to test and gain cross agency support for strengthening the investment management system across the State services. Our aim is to ensure the capital charge regime is integral, rather than an adjunct, to the public finance system.

36. The case for improving these leadership roles and systems is becoming increasingly important with the injection of new funding into government services post COVID-19 and the desire to monitor the long-term results of those interventions.

Credible investor confidence rating (ICR)

37. The independent report notes that the capital-charge regime and the ICR are driven by the same purpose in that they aim to maximise the investment management capabilities and performance of each individual agency. It suggests that if the ICR were modified to include a financial perspective (for example focusing on balance sheet performance), it could further reinforce the government's imperative for agencies to use their assets efficiently and not hoard capital.

38. The report also briefly contemplates the idea of expanding the array of ICR implications to include changes in capital charge rates according to assessed performance but notes this would require changes to the current policy settings. We have reservations about the practicality of this idea.

39. We are concurrently reviewing the ICR. It has been in place since late 2015 and there have been two full rounds of assessment activity across 24 investment-intensive agencies. The ICR review is presently consulting with stakeholders over options that could improve the efficiency and impact of the ICR, including the point above about potentially bringing a financial performance perspective into the ICR.

Targeted baseline reviews

40. The independent report evaluated baseline reviews as a possible replacement for the capital charge regime, noting that the baseline review methodology is still evolving. The purpose of these reviews is to shed light on the impact of baseline spending over time and identify opportunities to improve value for money within the baseline or across government.

41. Rather than agencies facing an additional expense (and thus a financial disincentive) for holding surplus capital, efficient asset management strategies could be co-determined alongside Treasury. By identifying weaknesses in agency baselines and freeing up this funding, an agency would become more effective in addressing cost pressures.

42. We agree with the report that there are quite different costs and benefits associated with baseline reviews compared with the capital charge regime. Potentially, more frequent or more intensive reviews of baseline spending could yield greater transparency over agencies' spending decisions and enhance the communication between Treasury and individual agencies. At the same time, such reviews require significant data and information collection and analysis and require a mature methodology to underpin them.

Robust cost benefit analysis

43. The independent report explores the potential for cost benefit analysis (CBA) to replace the capital charge regime, in particular whether the requirement to carry out CBAs could be implemented more strictly, both for new and existing expenditures, if there was no capital charge regime.

44. It states that CBA can help quantify the trade-offs and opportunity costs associated with decisions on allocating taxpayers' funds between different options. However, it says that in practice, CBA has many limitations. The report places CBA on a list of options that it considers is not worth further investigation as a replacement for capital charge. We support that conclusion.

45. The report does however state that CBA is a useful tool to include in Better Business Case and other investment evaluations. This is consistent with our previous advice that there is a need to lift the quality and use of cost benefit analysis, to inform decision-making both in Treasury and across the system.

Risks

46. As with any system changes the main risk is failure to bring stakeholders on the change journey. That risk is mitigated when stakeholders understand the interplay between the parts of the system. The Treasury has a key role to play in leading change and influencing others.

47. Even though government changed its capital charge funding policy on Health capital investments in Budget 2019 there may be residual concerns amongst some DHB stakeholders about the place of capital charge in that sector. The government's response to the HDSR provides the main avenue for managing any residual concerns about capital charge in the DHB sector.

Next Steps

48. We invite you to share this report with selected Ministerial colleagues who may be interested in this matter.

49. We would appreciate the opportunity to discuss this report and next steps with you as soon as practicable. The purpose of the discussion would be to ensure the system settings, including the capital charge regime, contribute to achieving the Government's broader wellbeing objectives.

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	s9(2)(k) [redacted]	s9(2)(g)(ii) [redacted]	✓
Davin Hall	Principal Advisor, Health team	s9(2)(k) [redacted]	s9(2)(g)(ii) [redacted]	
Carolyn Palmer	Manager, Health team	s9(2)(k) [redacted]	s9(2)(g)(ii) [redacted]	

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 $55 million per annum ongoing ($32 million 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.	*Agree/disagree.*
Minister of Finance	**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.	*Agree/disagree.*
Minister of Finance	**Minister of Health**

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

Agree/disagree.	*Agree/disagree.*
Minister of Finance	**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.	*Refer/not referred.*
Minister of Finance	**Minister of Health**

Carolyn Palmer
Manager, Health & ACC

Hon Grant Robertson	Hon David Clark
Minister of Finance	**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.

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[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. s9(2)(g)(i) [redacted]

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]

15. In our work to date we have set out a long list of options that we think would improve, in varying degrees, aspects of the current system settings in the DHB sector. These range from options that could work under current institutional arrangements (ie 20 DHB companies and a Ministry of Health) through to more speculative options that involve varying degrees of change in asset management responsibilities.

16. The continuum of options includes:

a Making administrative changes (such as modifying the capital charge regime, or changing how capital charge is presented for sector financial performance reporting purposes).

b Strengthening accountability and reporting under current institutional arrangements (for example fully adopting the intent of the Investor Confidence Rating or changing investment decision thresholds or changing the mandate of the Capital Investment Committee).

c Strengthening investment management functions in the Ministry and across the sector (such as those referred to in paragraph 6 above).

d Transferring DHB assets to the Crown account rather than holding them on DHB balance sheets.

e Adopting new regional or consolidated asset ownership arrangements potentially associated with broader changes in how health services are delivered.

17. We have also formed a preliminary view of the extent to which each of the identified options would satisfy the objectives set out above, compared with the status quo. The analysis is presented in summary form in Annex 1.

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 $55M ($32 million 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. Some of these could be actioned relatively quickly for example changing some of the decision thresholds that have been in place for nearly 20 years.[4] Ideally, any immediate policy changes (ie in 2019/20) would be equally applicable under current or future institutional arrangements.

40. In our own analysis of current and potential future capital settings we considered the merits of some structural options that would take longer to put in place, such as transferring assets to the Crown account or to new asset owning entities in the sector). Our preliminary analysis suggests that some centralisation of functions is more likely to achieve the system objectives set out in this report, compared with other options.

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.

Annex 1: Preliminary assessment of relative impact of different types of system improvement options

		Options under current DHB institutional arrangements				Options for alternative asset management arrangements	
Objectives of system settings: to improve…	…by…	Status Quo	Make administrative changes	Strengthen accountability and reporting arrangements	Strengthen investment management functions in the Ministry and across the sector	Transfer DHB assets to the Crown account	Adopt new regional or consolidated asset ownership arrangements
Effectiveness	...identifying and delivering the right investments and fit for	⇩⇩	⇔	⇧⇧	⇧⇧	⇔	⇧
Efficiency	...delivering required investments & levels of asset performance	⇩⇩	⇧	⇧	⇧⇧	⇔	⇧⇧
Sustainability	...delivering affordable health services over time	⇩	⇧	⇧	⇧	⇧	⇧⇧
Resilience	...anticipating, responding to and coping with adverse shocks	⇔	⇧	⇧	⇧	⇔	⇧⇧
Adaptability	...managing or responding to significant long term trends	⇩⇩	⇔	⇧⇧	⇧	⇔	⇧⇧
	Key: Likely impact on system objectives	Large negative impact	Negative impact	Neutral impact	Positive impact	Large positive impact	
		⇩⇩	⇩	⇔	⇧	⇧⇧	

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	✓	✓	✓