The Treasury

Budget 2024 Information Release

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Approach to Health Capital Funding Settings

Date:	27 July 2023	**Report No:**	T2023/1052
		File Number:	SH-1-8-1-2-M96420

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance** Hon Dr Ayesha Verrall **Minister of Health**	**Agree in principle** to a single year capital funding model at Budget 2024 Or **Agree in principle** to a hybrid capital funding model at Budget 2024 Or **Agree in principle** to a multi-year capital funding model (2024/24 to 2026/27)	27 July 2023

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Warner Peel	Analyst, Health	[39]	[35]	✓
Jess Hewat	Manager, Health			

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Approach to Health Capital Funding Settings

Executive Summary

This report responds to a Cabinet request that officials from the health entities and Treasury report back to Joint Ministers on the alignment of health capital funding to health operating in Budget 2024 (CAB-22-MIN-0132 refers). The report back covered:

- the alignment of capital to the multi-year funding of operating expenditure in Budget 2024
- the allocation of capital charge and possible replacement with an alternative mechanism; and
- the use of commercial lease and financial arrangements to deliver non-core services and support community providers and primary care.

Operating and capital funding have been treated separately in multi-year health planning to date. Operating funding has been the primary focus for officials due to its size and complexity. Directly comparing these types of funding is also challenging with capital and operating expenditure having distinct planning, spend and delivery profiles with expenditure occurring at different stages.

The current maturity of the health system makes it difficult to forecast health capital costs with certainty. Operating funding has a robust top-down funding model; however, the health capital system is still working to understand expected costs. Officials consider these funding mechanisms can remain separate in the short-term, if operating costs associated with capital are appropriately considered in Budget 2024.

If operating and capital remain separate, Ministers have options around how capital is funded. These options include single-year funding, hybrid funding using an indicative funding track, and full multi-year capital funding. Te Whatu Ora has some existing multi-year elements with the ‘Health Capital Envelope’ appropriation enabling multi-year trade-offs, but not of the scale and certainty of a three-year funding settlement. Agencies still see the benefits of multi-year capital funding in the long-term but recognise the need for a mature system to fully achieve the benefits.

Monitoring agencies consider the reform programme within Te Whatu Ora to be focusing in the right areas, but we do not think current investment systems and processes will get the most value out of multi-year funding in Budget 2024. We are also conscious of the constrained fiscal environment and significant demand for capital funding in upcoming budgets. It is important that Budget capital investment decisions are underpinned by good information and planning.

Agencies consider the shift to multi-year capital funding should be deferred until health reforms are further embedded. The Treasury and Manatū Hauora recommend a single-year funding option to reflect current levels of maturity, and because it allows for the greatest funding flexibility in a fiscally constrained environment. Te Whatu Ora agrees with the need for increased maturity in its planning but has requested hybrid funding to align with its work programme without a full funding commitment. The Treasury notes that hybrid funding, depending on how it is implemented, could impact fiscal forecasts, and may constrain Ministers to a similar degree as full multi-year funding.

Health has unique capital charge settings with a specific tagged contingency established in Budget 2019 for the additional costs of new capital projects. We recommend these settings remain in the short-term until a more substantial review of capital charge can be completed across the national investment system. It will be necessary to assess the funding adequacy of the existing capital charge contingency ahead of Budget 2024.

The Treasury considers that the existing arrangements for alternative financing remain appropriate for Te Whatu Ora, noting that recent policy changes on alternative financing arrangements by Crown entities means that they need to have a commensurate central funding source. Te Whatu Ora will still be able to negotiate alternative financing arrangements, but in practice will need to prioritise such projects alongside other centrally funded initiatives. Te Whatu Ora notes that this may limit the potential benefits of alternative financing and will provide advice on exploring alternative financing after the Infrastructure Investment Plan is completed.

Recommended Action

We recommend that you:

a **note** operating and capital funding has been treated separately as part of the Budget 2024 planning process and that officials consider this separation can remain in the short-term

b **note** this gives Ministers separate options on the capital funding arrangements for Budget 2024, and

c **agree in principle** to single year capital funding model at Budget 2024 (*Treasury and Manatū Hauora preferred option*), subject to further design work

Agree/disagree.	*Agree/disagree.*
Minister of Finance	**Minister of Health**

Or

d **agree in principle** to a hybrid capital funding model at Budget 2024 *(Te Whatu Ora preferred option),* subject to further design work

Agree/disagree.	*agree/disagree.*
Minister of Finance	**Minister of Health**

Or

e **agree in principle** to a multi-year capital funding model (2024/24 to 2026/27), subject to further design work

Agree/disagree.	*Agree/disagree.*
Minister of Finance	**Minister of Health**

f **note** that Treasury recommends multi-year funding be reassessed ahead of Budget 2027

g **note** that Treasury officials do not recommend any changes to the capital charge mechanism and will provide further advice on the current contingency's sustainability as part of Budget 2024

h **note** that Treasury officials do not recommend any changes to the alternative finance settings for Te Whatu Ora at stage, since recent changes to the net debt fiscal indictors. and

i **note** this report is on the agenda for the Health Joint Ministers' meeting on 2 August 2023.

Jess Hewat
Manager, Health

Hon Grant Robertson **Minister of Finance**	Hon Dr Ayesha Verrall **Minister of Health**
_____/_____/_______	_____/_____/_______

Treasury Report: Approach to Health Capital Funding Settings

Purpose of Report

1. In April 2022, Cabinet requested that officials report to Joint Ministers on health capital settings by 31 July 2023 (CAB-22-MIN-0132 refers). This report back was to include the:

    i Alignment of capital to the multi-year funding of operating expenditure in Budget 2024.

    ii Future allocation of capital charge and the potential replacement with an alternative mechanism.

    iii Use of commercial lease and financial arrangements to deliver non-core services and support community providers and primary care.

2. This report has been prepared with Manatū Hauora and Te Whatu Ora, and Te Aka Whai Ora were consulted.

3. This advice seeks in principle agreement to budgeting arrangements for capital from Budget 2024-2026. Final decisions on funding settings will be sought later this year, following more detailed design work.

Context

4. The public health system in New Zealand has a significant asset base that delivers health services to New Zealanders. Historic issues have decreased Ministerial and public confidence in the health system to manage these assets and deliver the necessary improvements in line with expectations. The Health and Disability Review Interim Report (the Review) noted some of the challenges facing health capital, including:

    - Inconsistent investment planning processes and the need to link capital planning with long-term service planning.
    - The need for good asset management practice at a regional level and the gap of a comprehensive National Asset Management Plan.
    - Variable governance arrangements for programme and project delivery.

5. The establishment of Te Whatu Ora has centralised the health capital investment system into a single entity that provides more consistent asset management and programme delivery. It is important that the health capital system has effective funding settings that can act as a tool to support Te Whatu Ora build system improvements. Health capital funding settings should:

    - be flexible to investment needs
    - align with health reform and operating settings
    - encourage stronger long-term planning and,
    - support effective portfolio investment.

Budget 2024 will be challenging for health capital

6. The 'Health Capital Envelope' (HCE) enables multi-year investments and trade-offs across the health capital system. This appropriation was used to support major infrastructure investment that district health board's (DHB's) could not solely afford and is now the key appropriation for health capital funding.[1] Previously, 'top-ups' were made to the HCE on an annual basis, with a two-year transitional funding top-up agreed at Budget 2022. The HCE is under pressure with significant demand for new investment and cost pressures from existing projects leading to demanding trade-offs.

7. The health capital system has previously received, on average, approximately $700 million in annual budget rounds in recent years.[2] Budget 2024 will be challenging, with significant demand for capital funding across all portfolios and constraints in the market's ability to absorb spend. These pressures will force trade-offs and limit investment choices. A number of priority health capital projects have already been signalled for the next few years, although the costs for these projects are indicative at this stage (see table one).

[33]

8. In the context of the wider investment environment, these projects may limit Ministers' ability to make further decisions on capital funding in Budget 2024. It is important that funding settings remain flexible to allow Ministers to best manage the existing pre-commitments, need for new investment, and trade-offs with other sectors.

Te Whatu Ora is still building the foundations to manage health capital at a national level

9. Te Whatu Ora has a substantial programme underway to improve the management and delivery of health capital. The capital function is going through a significant transition, building on earlier work to establish the Health Infrastructure Unit, which transferred from Manatū Hauora. Progress is not where monitoring agencies expected it to be at this stage. However, key programmes are underway to centralise and embed health capital reform, these include:

   - Completing and embedding a national operating structure to both maintain current assets and deliver on the future needs of the system.
   - Embedding project governance processes to effectively manage ongoing investments.

[1] This does not include depreciation funding within the health system or New Dunedin Hospital, which has its own appropriation.

[2] Some large investments such as New Dunedin Hospital and the Mental Health Infrastructure Programme have not been included in this allocation.

- Developing the core planning documents for health infrastructure, the National Asset Management Strategy (NAMS) and the Infrastructure Investment Plan (IIP), which will provide a national lens to infrastructure planning and investment. These are appendices to Te Pae Tata | the New Zealand Health Plan and need to be completed by December 2023.

10. Monitoring agencies are supportive of these focus areas, but we are conscious that these are still the foundational elements of a mature investment system. Some key challenges remain in the system, such as understanding the full state of the asset base, nationalising the approach to managing existing assets and developing detailed planning that aligns infrastructure to the needs of future operating systems and models of care. Te Whatu Ora will report to Cabinet again in July 2024 on its progress to implement and embed the key programmes listed above, as well as other key reform activities.

11. Early engagement indicates that the first iterations of the IIP and NAMS will provide greater detail and national alignment than previous planning and prioritisation work. These are key deliverables to the multi-year funding system for health capital and form the foundation of multi-year planning. However, the IIP (the main capital plan) is being developed while asset management systems and information are still developing, which may limit its depth.

Separation of Operating and Capital Funding

Capital funding is being managed separately from operating funding…

12. Cabinet has agreed in principle, as part of the wider health reform, to change the funding settings for the health system. This would involve transitioning to a three-year funding from Budget 2024, subject to adequate system settings to support improved planning and financial control (SWC-21-MIN-0157 refers). This change is aligned with the broader goals of health reform by encouraging multi-year planning and building a health system that is more equitable, financially sustainable, and transparent.

13. Operating and capital funding planning was separated during this process, with operating funding being the main focus of the work to date, with resourcing limiting the level of consideration given to capital settings. This is partially due to the size of the Vote Health operating expenditure base. Joint Ministers continue to engage on the design of the multi-year operating arrangement, including assessing work against a series of preconditions for shifting to multi-year funding and quarterly progress checks (T2022/2607 refers).

14. Separating the operating and capital funding has allowed officials to assess the benefits of multi-year capital funding against the risks in the short-term, without impacting the much larger assessment of the operating funding system. Capital expenditure also follows a different planning and spend pattern to operating that makes them difficult to directly compare. Operating expenditure is typically ‘flatter’ in its spending profile and occurs at a steady rate. Capital is ‘lumpy’ with significant expenditure occurring at specific stages and then decreasing again. It is important that decisions relating to funding consider these profiles and the associated impact on output planning and delivery.

15. The degree of confidence the Treasury has in forecast expenditure for operating and capital is also different. For health operating, we have a robust top-down cost pressure funding model that has been developed over the last three years that draws off domestic and international evidence of health cost drivers. However, there is no equivalent model on the capital side. The limited visibility of capital investment expenditure for 2024-2026 at this stage also makes it difficult to accurately predict trade-offs within health capital and across other sectors. This means that, unlike for operating spending, shifting to a multi-year funding arrangement for capital without a bottom-up plan risks getting the overall funding level wrong.

16. This paper treats data and digital investment as out of scope. Data and digital investment has increasingly shifted to operating expenditure with capital elements and is best considered as part of operating new initiative choices. Data and digital elements of infrastructure builds should be factored into the programme plans and costs of new investments (for example Nelson Hospital). However, given the accumulated data and digital deficit across the health system, there will be a need to consider ongoing new investment each Budget. Further work on this will be done to inform our post-election advice on Budget 2024 for health.

. . . And officials think this separation can continue in the short-term

17. We do not think that Vote Health operating and capital requirements need to directly align in Budget 2024. The key risk to this separation is ensuring operating costs incurred through capital investment is funded. This is both the depreciation and capital charge requirements, and the consideration of workforce and maintenance requirements from new builds coming on-stream. Given the timeframes to deliver capital, we consider there will be enough information in the system to understand the operating costs over a multi-year profile.

18. We do not expect these costs to be significant over the next three years. We believe costs can be estimated for a three-year period (if operating funding proceeds with a multi-year track) through Budget 2024 and Ministers can continue to fund capital on a single year track if required. Te Whatu Ora agrees that this should be manageable. We expect that the Budget planning parameters communicated to Te Whatu Ora and Te Aka Whai Ora in March 2023 and disclosed in BEFU 2023 should be sufficient to fund operating costs related to capital, but Te Whatu Ora's bottom-up costing information through the Te Pae Tata financial annex will provide further assurance on affordability.

Options for capital funding settings

You have additional options for capital funding settings

19. If capital funding remains separate to operating funding, Ministers will be able to make independent decisions on settings. Officials have reviewed three core funding setting options, with possible variations of each that could be considered. These are:

    a Status quo – continuing through the annual budget process, with no pre-commitment or indicative spending for future years (*Treasury and Manatū Hauora preferred option*).

    b Hybrid funding – one-year appropriated funding with an indicative funding track *(Te Whatu Ora preferred option)*.

    c Full multi-year – three years of appropriated funding approved in Budget 2024 and pre-committed against Budgets 2025 and 2026.

20. There is an options analysis in **Appendix One** assessing these options against the objectives of the funding settings outlined in paragraph six, along with an additional criterion on how these options align with the broader health system reform context.

21. The Treasury notes that current settings, through the HCE, work in a similar way to multi-year funding with the ability to make internal trade-offs and multi-year investment decisions, but at a smaller scale through the amount available. The degree of difference between options mainly relates to scale of investment and flexibility of choice in years beyond 2024. The legislative requirements for a fully costed Te Pae Tata | NZ Health Plan (including capital) remain, no matter what option is chosen. However, we expect the costings for capital expenditure to be insufficiently robust to inform a firm three-year funding track.

22. The Treasury still considers multi-year funding for capital investments to be the best option for achieving health reform goals in the medium-term. Multi-year funding best enables portfolio level investment management, longer-term planning and aligns with the wider operating funding track. However, it is the most difficult option to implement and requires the greatest level of confidence in the system especially if Ministers want a firm three-year funding track.

Monitoring agencies consider single year to be the most appropriate option in the short-term

23. Committing to a three-year health capital funding settlement in Budget 2024 risks setting funding too high or too low because costings are not well developed. It also risks prioritising the wrong investments for a full three years due to information gaps prior to Budget 2024. Maintaining funding flexibility will enable the IIP and NAMS to improve and will support Ministers to make more informed decisions in later budget rounds.

24. The Treasury recommends Ministers agree in principle to their preferred funding setting to enable the design of budgeting arrangements to progress over the coming months. The Treasury and Manatū Hauora consider single year health funding the most appropriate to mitigate the risks outlined above and allow the health system to continue to embed reform without jeopardising future multi-year funding decisions. Single-year funding, as noted above, will still enable some flexibility for Te Whatu Ora through the HCE.

25. The Treasury recommends that any funding option agreed through Budget 2024 be considered as a temporary three-year measure while the system reform is properly embedded, with decisions on long term system settings taken in 2027. Because capital funding is so ‘lumpy’, with limited intervention levers after the initial investment is made, it is important that capital funding settings align to the maturity of the delivery agencies. We expect Te Whatu Ora’s maturity to improve significantly between Budget 2024 and Budget 2027. We recommend capital funding settings are reassessed through Budget 2027.

26. Te Whatu Ora’s preferred option is hybrid funding, with an annual funding allocation and indicative funding track over three years. Te Whatu Ora agrees that there are risks around moving to a three-year funding arrangement at this point as they are still developing systems and lifting maturity. However, the entity considers a hybrid model to be more in line with the agency’s maturity programme underway. Te Whatu Ora also regards an indicative track as the best enabler for supporting its multi-year planning work and will ensure alignment of Ministers and agency expectations in funding rounds. It would also act as a transitional stage to seeking full multi-year funding in Budget 2027.

27. Indicative funding through a hybrid-model, depending on how it is implemented, will impact fiscal forecasts, and may constrain Ministers to a similar degree as full multi-year funding. As a rule, the more certainty given to entities will increase the likelihood of needing to formally reflect this in forecasts. If this is Ministers' preferred option, advice on how to implement this option, including implications with fiscal reporting, will be provided after further design work.

Capital Charge

28. Cabinet agreed that officials would report-back to you on the future allocation of capital charge and its possible replacement with an alternative mechanism.

29. The Review found that capital charge were challenging for DHBs to absorb. The completion of significant infrastructure would increase DHB capital and lead to a sharp jump in capital charge costs. To manage these pressures, Cabinet approved a tagged contingency through Budget 2019 to provide additional funding to cover the increase in capital charge associated with capital contributions for new capital projects with effect from 2019/20 (CAB-19-MIN-0174.19 refers). This contingency is unique to the health sector.

30. We consider the current capital charge contingency to cover the increase in capital charge associated with new projects to be appropriate in the short-term as it relieves some potential cost pressure from the health system. Without a more fundamental cross-Vote review of capital charge, we do not think the current mechanisms should be replaced at this stage.

31. [33]

Alternative financing

32. Cabinet also agreed that officials would report back on the use of commercial lease and financial arrangements to deliver non-core services and support community providers and primary care.

33. Ahead of Budget 2022, Cabinet announced a new debt fiscal indicator that is broader than the previously used headline indicator (net core Crown debt). In effect, loans, or finance arrangements to Crown entities are now factored into net core Crown debt, where these would have originally been separate. This more closely aligns with net debt measures used internationally, and better captures borrowing under the control of the Government and assets that provide offsets to that borrowing.

34. This is not a change to existing policy settings. Crown entities are still able to take on debt arrangements with approval from both the responsible Minister and the Minister of Finance. It does constrain Crown entities to take on more debt without an existing funding source or an exemption from Cabinet and the case for seeking alternative financing will need to be clear. This means that seeking alternative funding arrangements will need a clear case for progressing the project through alternative financing as opposed to a Crown funding source.

35. Te Whatu Ora has undertaken an investigation of possible alternative financial arrangements that could support health delivery. Te Whatu Ora notes that this advice has identified benefits in alternative financing arrangements for car parking facilities at hospitals and the development of health community centres. Te Whatu Ora plans to provide advice on the options for exploring alternative financing of investments in those areas following the delivery of the IIP.

Consultation

36. Manatū Hauora, Te Whatu Ora and the Te Aka Whai Ora have been consulted and their feedback has been incorporated into this report.

Next Steps

37. Te Whatu Ora will continue its work developing planning documents and embedding the reform, with monitoring agencies engaged as needed.

38. Officials will provide Ministers will further advice on the preferred funding option after detailed design work.

Appendix One: Funding setting options analysis

Funding options	Flexibility to change investment decisions	Alignment with health reform and operating settings	Supports long-term planning	Effective management of the portfolio	System context
Status Quo – Annual Budget rounds	Enables Government to make annual investment decisions in line with annual priorities	Does not directly align with wider health reform goals, including the transition to multi-year funding. Risks putting capital out of alignment with operating.	Provides less funding certainty to encourage multi-year planning.	Planning at a portfolio level is more difficult as funding is approved annually and will likely be project based. Other mechanisms can provide for this.	Least complex to implement and closely aligns to the maturity of the system.
Hybrid funding – three-year indicative funding track with funding approved annually	Some flexibility for investment decisions. Could be difficult to deviate from the funding track depending on sector and public expectations.	Does not align to operating funding (dependent on final decisions on operating). Partially aligns to the multi-year intent of the reform.	Signals multi-year funding and may encourage longer-term planning processes. Level of benefit depends on implementation.	Enables some portfolio level management based on indicative funding levels.	Will encourage multi-year planning. The level of commitment depends on how it is implemented and how funding levels are communicated to entities.
Multi-year – three-year settlement with one-year indicative rolling	Limited flexibility for new investment. Adding (or removing) funding will undermine the settlement process.	Aligns with operating funding (dependent on final decisions on operating) and most closely aligns with multi-year reform intent.	Will encourage multi-year planning but is dependent on other key products, including the IIP and NAMS.	Would encourage Te Whatu Ora to manage investments on a portfolio basis and make internal trade-offs.	Most complex to implement and relies on a mature investment system to deliver effectively.