

Chair  
CABINET SOCIAL POLICY AND HEALTH COMMITTEE

**LIMITS ON DISTRICT HEALTH BOARD ACCESS TO PRIVATE SECTOR FINANCING AND TRANSITIONAL IMPLICATIONS FOR HOSPITAL AND HEALTH SERVICES**

**EXECUTIVE SUMMARY**

**District Health Board Financing**

1. Cabinet has agreed that, in principle and subject to the further work described here, District Health Boards (DHBs) will not be given powers to access private sector finance, other than for working capital [CAB (00) M 20/4 refers]. This report advises on:

- ?? whether there is a level of project below which DHBs should be able to access private sector financing; and
- ?? the appropriate use of working capital by DHBs.

2. Analysis of the benefits and risks of private sector involvement shows no compelling reasons for allowing some limited private sector funding for any long-term, internal DHB requirements. It is recommended that DHBs should not be given powers to borrow from the private sector to meet long-term needs and that the Crown should provide all normal long-term financing for DHBs.

3. The provider arms of DHBs will require working capital. If the Crown is providing

## PROPOSAL

6. Cabinet has [CAB(00) M 20/4 refers]:
- c i agreed in principle, subject to the further work in (c)(ii) that DHBs will not be given powers to access private sector finance, other than for working capital;*
  - ii directed officials to report to SPH as soon as possible on whether there is a level of project below which DHBs should be able to access private sector funding and the guidelines/prudential limits which could be applied for such projects;*
  - iii directed officials to report to SPH with further advice on establishing a Crown financing agency (such as the Residual Health Management Unit) to provide Crown debt finance to DHBs, and the implications and process for refinancing existing Hospital and Health Services (HHS) private sector financing.*
7. This report:
- ?? provides the advice requested in (c)(ii) and the second part of (c)(iii) above<sup>1</sup>; and
  - ?? addresses the question of the appropriate use of working capital<sup>2</sup> by the provider arms of DHBs and whether any limits should be applied on DHB access to working capital.

## COMMENT

### DHB Financial Operating Environment

8. DHBs will have three dimensions of performance [CAB (00) M 15/10 refers]:
- ?? funding of health and disability services;
  - ?? governance and operational management of the DHB; and

10. It is likely that financing needs for the funding dimension of DHBs will differ from the other two dimensions. It is not envisaged that there will be a requirement for short or long-term debt facilities in relation to the DHBs' funding functions. In contrast, the provider arms of DHBs will require both long-term debt financing and short-term working capital.

11. Policy work on management of the funding functions of DHBs is still in progress and will be reported on separately. The following analysis is restricted to the provider arms of DHBs.

### **Access to Private Sector Finance**

#### ***DHBs' Need for Financing***

12. DHBs potentially have three sources of finance for new and ongoing investment:

?? free cashflows generated from operating activities;

?? borrowing, either by direct bank lending and/or issuing of instruments such as bonds and commercial paper; and

?? equity.

13. Normal operating costs also include depreciation. Depreciation, as a non-cash cost, has the effect of setting aside cash that can be used to improve or replace capital items. If a DHB achieves break-even then it will have a cash surplus, approximately equal to its depreciation, which can be used to fund investment.

14. By using a combination of normal cashflow and depreciation DHBs will be able to fund smaller investments from within their own resources and without the need for additional long-term debt or equity. Long-term external financing should only be required for major projects creating long-term assets.

#### ***Access to Private Sector Finance - Advantages***

15. Cabinet have agreed that long-term debt financing for DHBs shall be from the Crown but have asked if there would be advantages to allowing some limited access to

18. We note that the Minister of Finance will have the ability to authorise private sector borrowing on a case-by-case basis under Schedule 3 s41 of the New Zealand Public Health and Disability Bill. It is expected that this provision would not be used for routine transactions, but will provide flexibility to deal with unforeseen circumstances.

19. The need to manage performance of the CFA is a significant issue. However there are several ways of achieving this and continual ad hoc comparison with the private sector is not required.

#### ***Access to Private Sector Finance - Disadvantages***

20. We have previously advised on the disadvantages of allowing private sector funding for DHBs. These disadvantages include:

- ?? the additional cost of private sector finance, which is typically 0.5-1.0% but can be up to 5% in the case of some leasing arrangements. Experience to date with HHSs shows no significant benefit obtained for the extra cost involved;
- ?? the difficulties of avoiding an implicit Crown guarantee; and
- ?? the potential for tax avoidance. As DHBs are to be non-taxable allowing access to private sector debt is likely to create tax avoidance opportunities.

21. The disadvantages described above apply to all long-term private sector investment, irrespective of the size of the project. In addition to these general disadvantages there are some additional disadvantages of allowing private sector financing for small projects only. These include the:

- ?? requirement for subordination of Crown debt to the private sector debt. It is highly likely that private sector creditors would demand first call over DHB assets. It would not be appropriate for the larger Crown debt to be subordinate to smaller private debt; and
- ?? potential to split large projects to get under a 'prudential hurdle' and thereby avoid Crown scrutiny.

#### ***Access to Private Sector Finance - Conclusion***

creditors. These timing differences will be bridged by the use of short-term financing facilities such as an overdraft.

24. Cabinet has agreed that DHBs will be able to access private sector funds for working capital [CAB (00) M 20/4 refers]. This will enable DHBs to meet short-term cash needs.

25. There is a risk that unrestricted access to short-term private sector funds could lead to their inappropriate use as an alternative source of long-term finance. This problem can be managed by placing restrictions on the use of these instruments.

26. It is recommended that DHBs be directed to limit their short-term credit facilities to an amount equivalent to their provider arms' planned monthly revenue. This means that private sector credit lines should regularly fluctuate back to zero and will ensure that short-term funds do not become long-term debt.

27. It is recommended that officials be directed to review DHB working capital use by 1 July 2001 and report to Ministers on any steps necessary to amend these prudential limits.

## **Transitional Issues**

### ***Existing Private Sector Debt***

28. HHSs have a variety of existing financing arrangements with the private sector, including some with terms of ten or more years. These arrangements could be allowed to continue to maturity or could be refinanced through the CFA.

29. The table below summarises our understanding of existing HHS debt maturity.

<b>Maturity Date</b>	<b>Amount (\$M)<sup>3</sup></b>
Oct / Nov 00	\$5.2
Dec 00 – Jun 01	\$128.5
Jul 01 – Jun 02	\$60.3
Jul 02 – Jun 05	\$504.2
After Jul 05	\$42.9

?? allow for a gradual transition to Crown provision of DHB debt finance; and

?? avoid the potential for costly early repayment penalties.

32. We recommend that following the establishment of DHBs, each DHB be given the option of retaining the private sector financing arrangements of its HHS predecessor or refinancing with the Crown. Any penalty costs from early repayment would be the responsibility of the DHB.

33. When the private sector finance is due for repayment DHBs may approach the Crown for refinancing or reduce existing debt levels without refinancing.

34. We note that once DHBs are established, the Crown will have the ability to require refinancing through the CFA at any point in the future, should Ministers so choose.

#### ***Transfer of Existing HHS Assets and Liabilities to DHBs***

35. There is a risk that the formation of DHBs from the existing HHSs may trigger clauses in HHS private sector financing contracts for the repayment of loans. However, we consider that demands for the early repayment of existing HHS loans are unlikely to occur because:

?? such a course of action could potentially be expensive for financiers;

?? it could have effects on the reputation of the financiers; and

?? establishing DHBs is likely to increase the security of existing financing arrangements.

36. The Crown does not guarantee any existing HHS borrowings. The creation of DHBs and transfer of assets and liabilities from HHSs to DHBs will not in itself trigger any guarantee or other obligations so long as any contract relating to those assets and liabilities was made under New Zealand law. No Crown guarantee will be triggered because the entity still exists, but in another legal form, i.e., a statutory corporation rather than a limited liability company.

#### ***Crown Financing Agency for DHB Debt***

39. However, any debt finance provided to individual HHSs/DHBs that is additional to current debt levels will impact on the Government's capital expenditure provisions.

40. There is no existing Crown financing appropriation for the purposes of lending to HHSs or DHBs.

41. For 2000/2001 up to \$145.6 million has been approved to provide equity finance to Hospital and Health Services from Vote: Health *Capital Contributions to Other Persons or Organisations, Capital Injections to HHSs*.

42. This amount is insufficient to provide finance to meet all expected Hospital and Health Service debt and equity financing requirements over the next 12 months.

43. We have directed officials to prepare a report for Cabinet seeking approval for an increase in vote: Health *Capital Contributions to Other Persons or Organisations* to meet the expected financing requirements of Hospital and Health Services and District Health Boards over the next 12 months.

## **CONSULTATION**

44. The Treasury has consulted with the Ministry of Health and RHMU in the preparation of this paper. Officials have also consulted with the Crown Health Association and some HHSs on the working capital issues.

## **LEGISLATIVE IMPLICATIONS**

45. There are no legislative implications.

## **REGULATORY IMPACT STATEMENT**

46. A regulatory impact statement is not required.

## **HUMAN RIGHTS ACT**

47. There are no Human Rights Act implications.

## **PUBLICITY**

**AT THE MEETING ON 3 NOVEMBER 2000, FOLLOWING REFERENCE FROM THE FINANCE, INFRASTRUCTURE AND ENVIRONMENT COMMITTEE, CABINET:**

FIN (00) M 32/1

**LIMITS ON DISTRICT HEALTH BOARD ACCESS TO PRIVATE SECTOR FINANCING AND TRANSITIONAL IMPLICATIONS FOR HOSPITAL AND HEALTH SERVICES**

**Private Sector Finance: Working Capital**

- a. **agreed** that District Health Boards (DHBs) will not be given authority to access new private sector finance, other than for working capital;
- b. **noted** that in the rare event that DHBs need to access private sector finance for purposes other than working capital they will require specific authorisation from the Minister of Finance under Schedule 3, section 41 of the New Zealand Public Health and Disability Bill;
- c. **noted** that the funder arms of DHBs are unlikely to require working capital;
- d. **agreed** that working capital facilities for a DHB's provider arm be limited to a value equal to the provider arm's planned monthly revenue;
- e. **noted** that officials have been directed to review DHB use of working capital by 1 July 2001 and report to shareholding Ministers on any steps necessary to amend the prudential limit referred to in paragraph (d) above;

**Transitional Arrangements for Existing HHS Debt**

- f. **agreed** that DHBs be given the option of transferring existing Hospital and Health Service (HHS) private sector debt to the proposed Crown Financing Agency (CFA) [FIN (00) M 32/2 refers], or leaving it in place

- i. **noted** that this appropriation is insufficient to provide finance to meet all expected HHS and DHB debt and equity financing requirements over the next 12 months;
- j. **directed** officials to report to the appropriate Cabinet committee seeking approval for an increase in Vote: Health Capital Contributions to Other Persons or Organisations, to meet the expected financing requirements of HHSs and DHBs over the next 12 months.