



Briefing for Incoming Minister

November 2008

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1.0 Overview

1.1 Background

The Crown Health Financing Agency (CHFA) is a Crown Entity under the New Zealand Public Health and Disability Act 2000 and is categorised as a Crown agent for the purposes of the Crown Entities Act 2004.

Previously known as the Residual Health Management Unit [RHMU], CHFA has been in existence since 1993. It was originally established to manage and resolve a number of residual assets and liabilities that could not be transferred from Area Health Boards to the then newly established Crown Health Enterprises. Only resolution of some contingent liabilities [medical claims] and management of the lease at Tourism and Travel House expiring in September 2012 remain. Management of the Southland patient trust funds was added in 2001.

A "Disposal of Surplus Property" function was added in 2001 and CHFA was assigned the role as the sole provider of long term funding to District Health Boards [DHBs] in 2002.

Composite Terms of Reference updating these functions and broadening their scope to include the provision of property advice and financial advisory services were agreed in August 2005.

In 2007, CHFA participated with the Ministry of Health and Treasury in a joint assessment of its strategic direction. The review confirmed that CHFA should continue on with its core lending, property and residual functions. Additional opportunities for CHFA were also identified primarily in the areas of DHB asset management planning and capital allocation processes.

1.2 Our Business

CHFA is organised within three "lines of business":

Lending

We are the term lender to the DHB sector and provide a range of loan facilities to refinance existing private sector debt or to finance new capital investment. We provide an independent line of advice to the Ministers of Health and Finance of the assessed risks to the sector's financial sustainability.

Property

We assist DHBs with the disposal or acquisition of property to meet future service needs. We also offer advice to DHBs to achieve efficient use of their property estate including ownership, management, occupation and use.

Financial services

We manage a range of residual functions on behalf of the Government, and have a mandate to provide financial and analytical support to DHBs to assist them achieve the Crown's objectives for cost effectiveness and value for money.

1.3 Future direction

CHFA Board strongly supports the outcome of the recent strategic review and has placed an emphasis on enhancing existing CHFA services while remaining sensitive to actively identifying new opportunities to assist the DHB sector to achieve gains in cost effectiveness and value for money.

This includes the requirement to further develop our networks and relationships across the sector, our performance monitoring and financial analysis, and our capability to deliver expert advice and projects that contribute to achieving a sustainable DHB sector.

In summary, our vision of the future is:

1.3.1 Lending

To continue to provide the core lending services and seek to broaden our influence and participation in certain sector financial sustainability policy initiatives and their implementation

1.3.2 Property

To continue to provide the core property disposal and advisory services and seek to develop opportunities to contribute more widely to:

- Policy initiatives affecting the DHB property estate
- Property development [for community-based facilities]
- Regulatory and compliance issues

CHFA management observe that property practices across the sector lack consistency in approach and standards. In such a complex environment the sector is also susceptible to a high degree of financial risk for noncompliance with legislation and building regulations. There is a strong argument for the establishment of a small pool of expert advice to assist DHBs in these areas.

1.3.3 Financial Advisory Services

To manage/resolve the residual functions

To offer support for DHB collaborative efforts aligned to our core functions and introduce expert advice where needs are identified.

1.3.4 The wider state sector

The Board has previously stated its interest in offering the services of CHFA to the wider state sector. The Board is not currently authorised to develop this interest. However it continues to hold the view that the type of expertise held by CHFA could potentially be of use to other organisations in the State sector, and that some sort of consolidation or coordination would have potential efficiency gains for the Government.

Suffice to say here however that we are regularly approached to share our knowledge and experience and we consider in particular that our expertise and success in property disposal could be usefully shared with others.

2.0 Lending

Debt funding of DHB assets is considered desirable because lenders typically impose independent financial monitoring and discipline in protection of their loans. By 2000, however, a perception arose that private sector lenders were failing to impose such monitoring and discipline, due to an assumption that DHB credit risk is *de facto* equivalent to Crown credit risk.

CHFA was therefore appointed as the sole provider of term debt to DHBs in 2000, to re-finance existing private lending and provide any future term lending requirements. Although CHFA debt is both cheaper and more flexible for DHBs than Crown equity, the Lending function's *primary* objectives remain focussed on financial monitoring and discipline – specifically:

- To provide Ministers with high-quality independent advice on the assessed risks to sector financial sustainability, and
- To influence sector participants to address such risks as they arise.

The Lending function is well-established, with loan application, credit assessment, and monitoring procedures similar to those practiced by commercial banks. Its relatively narrow “lender’s perspective” differs significantly from that of other stakeholders, whose interests include wider “ownership” or “service delivery” issues rather than simply financial sustainability.

As at June 2008, lending limits of \$1.5 billion had been established, of which \$1.3 billion had been drawn. Private sector debt has been almost entirely re-financed [only \$120 million of Auckland DHB bonds remain], and CHFA’s new lending is limited to the funding of major new capital projects.

CHFA’s Lending activity is currently focussed on:

- Providing efficient debt funding to DHBs by establishing and maintaining commercial lending documentation, a low-cost source of funding at the NZ Debt Management Office, and a commercially appropriate spread of debt maturities over time
- Monitoring DHBs normal operations and assessing whether projected cash flows from operating activities and capital investments will be sufficient to meet liabilities in an orderly fashion
- Assessing the affordability of business cases presented to the National Capital Committee and advising the Committee whether the projected cost of construction is reasonable, the amount of funding requested is sufficient, and the on-going cost of the project [after completion] can be reasonably met from normal business operations
- Identifying potential structural risks to the financial sustainability of the sector. For example whether the recent pattern of cost inflation can be sustained, and whether the current devolved, break-even sector model is capable of delivering sustainable cost inflation without a material diminution in service levels

The last of these is a relatively new activity, with CHFA having previously focused on individual DHBs rather than the consolidated sector. Key sector-wide issues that we have recently drawn attention to are summarised in the tables on the following page. Of particular interest to CHFA are:

- The fact that cost inflation over the past three years has significantly exceeded nominal GDP growth [annualised rates are 8.79% and 5.81% respectively]
- The risk that the much lower projected cost inflation over the next three years [4.65% annualised] may not be achievable. It is noted that much of the recent cost inflation has been in staff-related costs, a significant portion of which flowed from policy-driven "pay joits", and that the industrial relations environment is reasonably settled at present. Nevertheless, for the sake of illustration, cost inflation over the forecast three-year period equal to that over the past three years would generate a funding gap in excess of \$1.6 billion by 2010/11.
- The fact that sector capital spending has exceeded [and is budgeted to continue to exceed] depreciation costs by a significant margin [over the 7-years to June 2011, capital spending averages almost 160% of depreciation]. Although this pattern may not be unreasonable, it highlights that no provisioning for future capital investment is possible, and that the sector's capital costs will therefore continue to rise.

CHFA considers that these issues are unlikely to be adequately addressed under the current structure of 21 devolved DHBs, and that significantly greater central leadership and co-ordination is required. Such increased "centralisation" could be reasonably achieved either regionally [for example, more than 40% of national Inter-District Flows are between Auckland, Counties-Manukau and Waitemata], or through central agencies.

Our experience with the collective insurance initiative suggests that because of the inconsistencies between District, Regional, and National interests some degree of central intervention and/or direction will be necessary to give effect to what we perceive to be the required behavioural changes. That is, a formal reduction of DHB "sovereignty" in favour of regional bodies and/or central agencies will be necessary to facilitate the necessary planning improvements in service provision, asset management, and human resource management.

CHFA is aware of a number of Ministry initiatives aimed at addressing these issues – for example, the Long-Term System Framework, and the Asset Management Improvement Group [to which CHFA contributes]. The extent to which these initiatives will be sufficient to restore long-term financial sustainability is yet to be assessed.

Additional Background Information:

For the sake of completeness, a summary table from CHFA's 30 June 2008 Annual Credit Review is included after the financial data below. Each DHB has been assigned a credit rating of A, B or C where A is ranked as Good and C, "At Risk".

Ratings in brackets are those that were assigned in the previous year.

Annual DHB Credit Review 2008

Appendix 1 - Sector Summary (prior year rating in parentheses)

--un-audited accounts to Jun-08

--May DAP for 2008-09

--Cash position as at Jul-08

DHB	Rating	Rationale
Northland	A (B)	Breakeven forecast credible. Cash reserves more than sufficient to meet all capex plans (including NCC project) and any foreseeable financial deficit.
Waitemata	B (B)	Projected significant deterioration in P&L caused by "one-off" spending items, and a return to break-even is considered credible. Cash at hand is more than sufficient to cover capex plans (including NCC project).
Auckland	A (B)	Break even forecast appears credible. Large amount of cash at hand.
Counties-Manukau	B (B)	Projected deficit at risk of deterioration, but material cash flow pressures unlikely over the coming year. Longer term, the DHB will struggle to support the extent of new capital upgrades being planned over the next few years.
Waikato	B (B)	Projected surplus is credible and delivers strong operating cash flows. Reliance is placed on the continuation of such cash flows to meet the escalated cost of the current NCC upgrade.
Bay of Plenty	B (B)	Operating at a deficit, but limited risk of further deterioration. Risk of cash flow pressure from capex plans (including NCC project) is considered low.
Lakes	B (B)	Projected result considered achievable. Available cash (at hand, and from operations & asset sales) is more than adequate to meet capex plans.
Tarawhiti	C (C)	Relatively large deficit, with little tolerance for adverse variation. Cash available for required capex will likely be exhausted by June 2009.
Taranaki	B (A)	Deficit operations at risk of further deterioration. However, baseline capex requirements are low and cash at hand is adequate.
Hawkes Bay	C (C)	Substantial deficit operations, at risk of material further deterioration. No cash at hand with which to support operations or essential capex.
Mid-Central	B (B)	Deficit operations, at some risk of further deterioration. Capex plans exceed operating cash, but cash at hand is large.
Whanganui	C (C)	Large deficit operations, with risk of further deterioration. NCC project is now adequately funded, but operating cash flows are strongly negative with no cash at hand.
Capital & Coast	C (C)	Large deficit operations. Operating cash flows are strongly negative, with no cash at hand. Risk of shortfall in funding NCC project.
Hutt Valley	B (B)	Break-even operations at risk of deterioration. Required contribution to NCC project is considered achievable, but the DHB has little ability to absorb any such P&L deterioration.
Wairarapa	B (C)	Projected break-even at risk of some deterioration. Operating cash remains under pressure due to the historic back-log of deferred capex.
Nelson-Malborough	A (B)	Projected deficit appears likely to be improved upon. Although some uncertainty exists around the scope and timing of the NCC upgrade, cash reserves are adequate to meet unexpected financial deterioration.
West Coast	C (C)	Chronic negative operating cash flows cannot be resolved under current revenue settings. NCC proposal unaffordable.
Canterbury	B (B)	Projected break-even at risk of material deterioration, but baseline capex plans relatively low and significant cash at hand.
South Canterbury	A (A)	Break-even result appears achievable. Low risk of material cash flow pressure.
Otago	C (B)	Operating at significant deficit. Low revenue growth limits opportunity to improve. Ample cash at hand may be required to fund planned upgrade.
Southland	C (C)	Chronic deficit operations, with insufficient cash at hand to fund losses, capex plans, and scheduled debt repayment.

3.0 Property

In 1999, CHFA was assigned the function of assisting DHBs to dispose of surplus property assets thereby releasing funds from under performing assets for reinvestment in the sector. The property unit has subsequently developed a core competency in the management and disposal of surplus properties and compliance with all of the necessary regulatory processes.

In August 2005, the Property function was expanded to include the provision of other services including advice on acquisition, development, construction and rationalisation of DHB properties. A growing number of DHBs are seeking strategic advice from CHFA in these specialist property areas. Here the Board seeks to ensure that we:

- Maximise the use of DHB property estates
- Minimise DHB property costs
- Capture as much of the "development profit" as possible for the health sector

There is no Crown funding or appropriation available for the property functions. Capital funding for property purchases and all of our holding costs is provided for by way of bank loan. The function has an objective to break even and all of its costs are covered by way of risk sharing with DHBs in the disposal process and income earned from advisory and agency services. Incentives are appropriately aligned such that we are always focused on delivering the best possible financial outcome for our DHB clients. The Board is comfortable with these "commercial" arrangements and the risk sharing incentives available to all parties.

DHBs have always been free to seek the advice and assistance of others when selling surplus property or seeking property advice. However, the Board is certain that a central agency like CHFA can offer the sector many advantages and added value. These advantages include consistency in approach and assurance of compliance with sometimes very complex policy settings and regulatory requirements. The latter can be time consuming and in our experience very costly if not followed "to the letter".

From a DHB perspective, the major benefit from selling surplus property to CHFA is that most of the capital is released at the outset and without triggering the statutory clearance process. Other sale mechanisms require the DHB to have completed the clearance process before disposal can be effected. In our experience this may take up to two years. Later the DHB also stands to gain from the value added by CHFA in the selling process by way of a majority share of any surplus after CHFA holding costs have been deducted.

3.1 Key Risks

Historically CHFA has delivered significant surpluses to DHBs on disposal of their surplus property assets. This record, and the ability to achieve a break even financial result is now dependent upon CHFA managing two areas of significant risk.

3.1.1 Property clearance processes

We continue to experience significant delays in gaining the required disposal and statutory clearances.

For CHFA, time is of the essence given that unlike other government agencies it is reliant on commercial bank funding for property purchases and holding costs. The Board has a view that these processes can be improved and, notwithstanding the

environment in which it operates, would welcome the opportunity to address timeframes for compliance with regulatory requirements.

3.1.2 Current property market

There is potential for the property function to be adversely impacted by the continuing softening of the property market and the associated credit "crunch".

Properties currently owned by CHFA are mostly unique and typically appeal to property developers. Regrettably, property developers have been affected by an inability to obtain funding and higher interest rates. This is constraining the ability to dispose of existing properties.

Of the properties currently owned by CHFA, your attention is drawn to two in particular.

Claude Road, Epsom

This property has proven difficult to sell and it is possible that CHFA might not recover all of its costs. A provision for non-recovery of \$500,000 has been made in the accounts for the year ended 30th June 2008.

Napier hospital

CHFA holds an unconditional contract to sell this site. However the purchaser did not settle as required on 30th April 2008 and the matter is now subject to litigation to enforce the contract. A hearing in the High Court is planned for 26th November 2008.

In the event that the purchaser is unable to proceed, CHFA does not consider itself to be at financial risk.

3.2 ***Property portfolio***

Currently, the CHFA owns the following properties.

Purchased from	Property	Current status
Auckland	Claude Road	Part site under offer. CHFA has potential financial risk
Whanganui	Jubilee hospital	Have agreement to landbank
Wanganui	2 ground leases	Have agreement to landbank
Whanganui	1 ground lease	For sale.
Whanganui	Taihape section	For sale.
Hawkes Bay	Tuakana block, Napier	Have agreement to landbank
Hawkes Bay	Napier hospital site	Unconditional contract for sale in default. CHFA has no financial risk.
Canterbury	Queen Mary hospital	Transfer completed 31 October 2008. Have agreement to transfer part property to Dept of Conservation. Ngai Tahu have first option on balance. CHFA has no financial risk.

4.0 Financial Services (including the 'residual' functions)

CHFA is the legal successor to the Area Health Boards and when established in 1993 it assumed a number of statutory functions. Several of these "residual functions" have been resolved but two remain and a third, the constructive trustee for Southland DHB unclaimed patient trust funds, was added in 2001.

In August 2005, this function was expanded to involve the provision of financial advisory services to DHBs to assist them to achieve their business goals and objectives. This includes financial and analytical support for client initiatives, efficiency projects and the development and implementation of collaborative initiatives.

4.1.1 Residual functions

The Residual functions left with CHFA comprise:

- The property lease at Tourism and Travel house expiring in September 2012
- Southland DHB Patient Trust Funds [waiting on the Public Trust Office and Southland to agree the terms of an appropriate Trust Deed to enable us to release the funds which currently amount to \$546,300]
- Residual Contingent Liabilities [Medical claims].

The Contingent Liability portfolio amounts to some 712 claims against the former Area Health Boards and their predecessors. Except for the current psychiatric patients [in all 283 individual claimants] and Greenlane heart library claims [43 claimants], CHFA considers the rest to have been settled or unlikely to lead to any further legal action.

Psychiatric patients

It is unclear as to when the psychiatric patient claims will be resolved. These are substantial matters, with damages sought totalling in excess of \$143 million. Any settlement will require a new appropriation of funds.

CHFA is party to a whole of Government approach to resolving these and other similar historical allegations against the Crown.

The Board is committed to resolving these liabilities. However, advice from Crown Law suggests that the legal process could run on for up to 10 years or more. The cost of defending the claims is considerable and given current appropriation levels will be beyond CHFAs financial resources from 2009/10.

Greenlane heart library

Substantive progress has been made recently in resolving these claims. 41 of the 43 claimants have accepted our offer to settle out of Court.

CHFA has sufficient financial resources to meet the related settlement costs.

4.1.2 Financial Services

Our Composite Terms of Reference were updated in 2005, to provide CHFA with a mandate to engage with the sector and facilitate collaborative initiatives in the interests of achieving efficiency gains and cost savings. At the time we were talking to DHBNZ about the possibilities for a collective insurance programme. There was also the possibility of providing advisory services in the areas of supply chain management and procurement.

DHBNZ did appoint CHFA as project manager for the collective insurance programme. Although the outcome was most gratifying [savings of \$4.5 million have been achieved on the baseline 2004/05 year cost] the project itself was two years of very hard work and not altogether a positive experience. It caused us to reflect on our strategy to participate in national initiatives and to think long and hard about becoming further involved.

As a consequence we restated our intent to be "a medium term objective to work with the sector to promote collaborative initiatives". This strategy is now being advanced selectively and if outside of our area of expertise by way of introducing subject matter experts to the sector or individual DHB.

CHFA experience suggests that collaboration and collective endeavour across the sector is difficult to implement. Despite the best efforts of many, parochial interests, poor information and "sovereignty" often frustrate the process. Businesses with 21 subsidiaries would not ordinarily tolerate such behaviour and it seems that a stronger central mandate is required to ensure that such initiatives succeed.

CHFA is prepared to contribute its views and expertise to any review of the current operating frameworks.

5.0 Resources

The Board believes that it has sufficient resources to meet current levels of activity and to explore the additional opportunities that have arisen from the strategic review and its own assessment of DHB needs.

There has been no formal request for any increase in appropriation for at least the past five years. This is in spite of inflationary pressures and substantial increases in the costs of managing the residual portfolio. By way of example, budgeted costs in 2008/09 for medical claims and TT House are \$1,350,000 and \$746,000 respectively. This compares with actual costs of \$163,000 and \$535,000 for the year ended 30 June 2004.

CHFA has been fortunate in that it has been able to fall back on its reserves to cover these increases. It has also had the benefit of interest on its equity. However, and as signalled in recent years, its reserves will be depleted in 2008/09 and additional funding will be required to meet the costs of continuing to defend the medical claims. This is under active discussion with officials at the Ministry of Health.

Funding beyond this will be dictated to by any changes to the range of services provided by CHFA. The Board understands that any request for an increase in appropriation will need to be supported by a business case and costs/benefit analysis.

6.0 Summary

Over recent months CHFA has deliberately regrouped around its core functions. It is tightly focused on delivering quality lending and property services, financial advice and resolving the contingent liability medical claims.

Notwithstanding this, other opportunities aligned to CHFA core competencies where its independent analysis and opinion might have the ability to influence financial outcomes have been identified and are being actively pursued. These include sector initiatives involving:

- DHB asset management planning and future provisioning for capital investment
- Capital allocation processes
- Analysis and assessment of issues affecting sector long term financial sustainability

The Board is confident that CHFA offers a unique value proposition. Its mix of services, capability and knowledge could, with an appropriate mandate, add even more value to the sector's goals for cost effectiveness and value for money

APPENDIX 1: GOVERNANCE PROFILES

John Anderson LLB BCom [Otago]

Appointed to the Board in November 2007 and Chair from August 2008

John is Chairman of the Otago law firm Gallaway Cook Allan. He has been in commercial law since 1983 and specialises in securities law, intellectual property and company law.

Outside of his legal practice John is heavily involved in chairing boards and committees for various business and community groups in the areas of Bioethics, Crown property and Bio security, forestry and University accommodation. John also serves as trustee of a number of charitable trusts in Dunedin.

Kay McKelvie LLB MBA [Auckland]

Appointed to the Board in March 2007

Kay holds a number of board memberships. She is Chair of Waitemata District Health Board, Quotable Value and the Housing New Zealand Appeal Authority. She is also a Director of Tourism New Zealand.

She has previously been Chair of District Health Boards NZ, Chair of Finance and Property, Auckland City Council, a Director of the NZ Lotteries Commission and Professional Standards Director of the Auckland District Law Society.

David Moore MCom [hons], CA, Dip Health Ec

Appointed to the Board in March 2007

David is the Managing Director for Asia Pacific of the international consultancy firm LECG and head of its local health sector practice group. He has held a number of senior positions in the health sector and was the founding General Manager of PHARMAC and continues there as a Director. He is also a member of HISAC, the ministerial appointed committee on health information.

David is of Ngai Tahu descent.

Philippa Dunphy B.Hort Sci. CFA

Appointed to the Board in September 2008

Philippa has extensive experience in banking, finance and investment. She has worked with a wide number of New Zealand and offshore companies in the areas of capital raising, interest rate and currency risk management.

Governance experience includes Earthquake Commission board member for eight years and recent appointments to ACC, Shamrock Investments, Mint Asset Management, NZ Fast Forward Fund and NZ Post. Philippa has been a member of the selection committee for the Guardians of the NZ Super Fund since 2005.

June McCabe MBA

Appointed to the Board in September 2008

June has extensive experience in policy-making, banking and finance and has held senior management positions at Westpac Banking Corporation and Housing New Zealand.

She is currently Chairman, Excelerator of the NZ Leadership Institute at Auckland University and is a Board member at Television New Zealand Limited and New Zealand Venture Investment Fund Limited. Previously she was a director at ACC and Housing New Zealand.

June has tribal affiliations to Ngapuhi, Te Rawawa, Te Aupouri and Ngati Kahu.

We note that Philippa Dunphy and June McCabe were each appointed to the Board for a one year term only.