Tertiary Education Commission
Te Amorangi Mātauranga Matua

Aide-Memoire: Modelling of future ITP performance

To:	Hon Penny Simmonds, Minister for Tertiary Education and Skills
From:	Tim Fowler, Chief Executive, Tertiary Education Commission
Date:	11 June 2024
Reference:	AM-24-00390

Purpose

1. This paper provides you with our advice on the latest financial modelling received by Te Pūkenga for the former institutes of technology and polytechnics (ITP) business divisions. The modelling outlines forecast financial performance for the 2024 to 2028 period and has been prepared to help understand whether any business divisions could be financially sustainable if they were to be re-established as individual institutions.

2. It includes our preliminary views on the modelling assumptions used, the challenges that many ITPs will have in becoming financially sustainable, and an indication of the level of change that would be required for them to be viable standalone entities. It also covers some of the risks of using the subsidiary model to transition to standalone entities. This issue, and the use of urgent legislation, is also discussed in a recent paper from the Ministry of Education (METIS No. 1330444).

Executive summary

3. The key points in this paper are:

   - The ITP sector is forecast to report a cumulative deficit of [redacted] percent of revenue) in 2024. All former ITP business divisions are forecasting to report a deficit.

   - Based on the proposed changes to the funding system and enrolment growth, the deficit is expected to improve to [redacted] in 2025 [redacted] percent of revenue) with all ITPs except Open Polytechnic expected to report a deficit.

   - By 2028, only five ITPs are expected to report surpluses with the remaining ITPs reporting deficits. On a cumulative, unmitigated basis, the ITP sector is forecast to report a [redacted] million deficit over the 2024 to 2028 period.

   - Over the forecast period, domestic EFTS across the ITP sector are forecast to increase by 8 percent while full-fee international enrolments are expected to increase by 66 percent. Every ITP expects enrolments to increase year on year. This is an optimistic assumption. There is a key risk that enrolment levels are lower than forecast, and fewer ITPs reach a surplus position by 2028 (and deficit sizes increase), resulting in a very high financial risk to the Crown.

   - To address the deficit through personnel reductions, it is estimated there would need to be reduction of [redacted] across the network to return all

ITPs to a 3 percent surplus in 2026. Eight ITPs would need to reduce FTEs by 9(2)(b)(ii), 9(2)(f)(iv) [redacted] or more with six having to reduce FTEs by 9(2)(b)(ii), 9(2)(f)(iv) [redacted].

- We consider most ITPs would be unable to achieve such a large FTE reduction without resulting in considerable negative revenue impacts. In our view, wholesale staffing cuts (particularly if they are not related to a strategic plan) can easily lead to a downward spiral where reductions in expenditure continue to be needed in response to falling revenue from the previous round of cuts.

- For Ara and Open Polytechnic implementing cost-saving initiatives and reviewing how and what they deliver to learners is likely to put them on a pathway to viability.

- For most ITPs that have more critical and longstanding financial issues, we consider more wholesale changes to their operating models will be required. Such changes take time to deliver and are complex to implement. There is also considerable uncertainty around the effectiveness of such models and whether they will result in financially sustainable operations. This is an area that Te Pūkenga and the ITP sector has historically not been able to address.

- For those ITPs that require fundamental change, we consider that undertaking aggressive cost-cutting without a detailed understanding of the issues at each ITP and a clear vision for the future of delivery in that region will likely result in ongoing financial issues. While a slower approach, we consider a more strategic and thoughtful approach is required to protect the integrity and longevity of the vocational education system.

- We have recently engaged with Te Pūkenga, and it has committed to work with the TEC to establish a strong financial sustainability action plan as soon as possible. We also intend to use section 332 of the Education and Training Act 2020 to require Te Pūkenga to obtain specialist help to ensure the right capability and capacity is in place to support this work.

9(2)(f)(iv), 9(2)(g)(i), 9(2)(b)(ii) [redacted]

- A subsidiary that is established by Te Pūkenga is subject to the Companies Act 1993. Given the financial challenges facing nearly all ITPs, it will be essential for each subsidiary to be solvent when established and able to meet its financial obligations as they become due. If not, we consider it will likely be impossible to appoint professional directors to govern the new entities.

9(2)(g)(i), 9(2)(f)(iv) [redacted]

9(2)(g)(i) [redacted]

- The re-establishment of individual ITPs (firstly as subsidiaries and then as independent entities) will require nearly all ITPs to be recapitalised to ensure they have sufficient financial resources to meet their obligations as they fall due. Te Pūkenga’s cash reserves, the Budget 2024 contingency, and asset sales will help support recapitalisation of entities. Further work is required to understand how much exactly each ITP would require, and in a downside scenario. There is therefore a key risk to the Crown that further funding will be required, either on re-establishment or in the medium-term to cover ongoing deficits, capital needs, or transformation requirements.

- If sufficient funding is not made available, then there will likely be a loss of an acceptable level of vocational education and training across many regions of New Zealand.

Background

4. In February 2024, Te Pūkenga contracted seven specialist advisors to support its disestablishment and provide advice to Te Pūkenga’s Council, TEC, and yourself. Four of the specialist advisors were contracted to focus primarily on the ITP sector. These advisors had a range of ITP experience (with three of them being former ITP chief executives). As set out in AM-24-00418, the specialist advisors were tasked with providing advice on:

   - whether the re-establishment of an ITP in a certain region in 2025 could result in viable and sustainable operations.

   - if it is not immediately viable, what actions and initiatives can be implemented to support that ITP to become sustainable. This should include the consideration of mergers, cost-reduction initiatives, financial support from other stakeholders, utilising Open Polytechnic to support operations, and fundamental operating model changes.

5. 9(2)(f)(iv) [redacted]. The specialist advisors then worked with the senior management of each former ITP to make changes to assumptions (particularly around enrolments) and were also expected to incorporate any savings from potential cost-out activity.

6. On 23 May 2024, financial forecasts were submitted to the TEC for each former ITP based on them being re-established as standalone entities. The specialist advisors have approved all of the forecasts provided. While the analysis remains high-level, and we believe improvements to the modelling could be made to improve accuracy and reduce optimism bias, we regard the forecasts provide an appropriate indicative picture of the financial challenges facing the ITP sector.

Forecast performance by ITP

The forecasts show that most of the ITP sector is expected to report deficits over the next five years…

7. The results of the unmitigated forecasting exercise are shown in *Table 1*. Discussion of the assumptions used and the modelling approached are discussed in further detail in the next section. Overall, the forecasts show that nearly the entire sector will face financial sustainability challenges over the next five years. On a cumulative basis, the ITP sector is forecast to report a 9(2)(b)(ii), 9(2)(i) [redacted] deficit over the 2024 to 2028 period.

[redacted]

…with a gradual reduction in the size of the deficit over time due to increased enrolments…

8. The ITP sector is forecast to report a cumulative deficit of [redacted] of revenue) in 2024. All former ITP business divisions are forecasting to report a deficit. Ten of the 15 ITPs are expected to report a deficit over [redacted].

[redacted]

10. Nevertheless, in 2025, all ITPs except Open Polytechnic [redacted], are expected to report deficits. As a sector, the deficit reduces to [redacted] which is equivalent to [redacted] of revenue. Six ITPs are expected to report a deficit of [redacted] of revenue or higher.

11. By 2026, in addition to [redacted] report a break-even position as a result of continued enrolment growth. However, the remaining 12 ITPs continue to report deficits. By 2027, [redacted] is also expected to report a surplus while by 2028, [redacted] is forecast to report a surplus.

…however, more than half of the sector is still expected to report a deficit in 2028

12. Despite the optimistic assumption of continued enrolment growth in both domestic and international enrolments, nine out of 15 ITPs are still forecast to report deficits in 2028 with the overall sector reporting a deficit of [redacted]

13. While cost-reduction activity and operating model changes may reduce the size of the respective deficits, we consider it will be very difficult to move the entire sector to a surplus position without a combination of large-scale change [redacted].

14. It is important to note that we have reservations around the achievability of the ITP enrolment forecasts. If domestic and international enrolment growth was softer than expected, it will likely

lead to worse performance. Our views on the enrolment forecasts are discussed in more detail in the following section.

Assumptions used and modelling approach

The forecasts use the 2024 reforecast as the base year…

15. Forecasts for the 2024 to 2028 period have been prepared based on a reforecast of 2024 performance undertaken in May 2024. This takes into account financial performance for the first quarter of 2024, including the impacts of semester one enrolment trends. It also assumes that cost savings of 9(2)(i) [redacted] across the former ITPs are delivered. The reforecast for each business division was led by the former ITPs alongside the regional finance directors.

16. There are a range of assumptions that have been used by each ITP as part of the modelling. Some of these are consistent across all ITPs, while some have been adjusted by the specialist advisors in conjunction with regional finance directors and executive directors of each former ITP.

…while the common modelling assumptions look reasonable…

17. The key assumptions that are consistent across all ITPs are:

9(2)(f)(iv) [redacted]

- All domestic enrolment growth is assumed to be funded by the TEC. This is a sensible assumption but there is a risk in the current fiscal environment that the TEC will need to prioritise where it invests and not all enrolments will be funded, which would worsen performance over the medium-term. The Ministry of Education will provide advice on this issue as part of Budget 2025.

- A 2 percent increase per annum in tuition subsidy rates is assumed over the forecast period. We consider this is a sensible assumption and in line with assumptions used by most universities. Of course, given the tight fiscal environment, there is a risk that tuition subsidy rate increases are lower than this, which would worsen performance.

- The time-limited 4 percent increase in tuition subsidy rates for DQ Level 7 and above funding rates over 2024 and 2025 continues in 2026 and beyond (i.e. there is not a 4 percent decline in 2026). This is an optimistic assumption particularly when combined with the assumption that tuition subsidy rates increase by 2 percent per annum. If the four percent increase does not continue to be funded, overall financial performance will be worse.

- Domestic fees increase by 2.5 percent in 2025 9(2)(b)(ii), 9(2)(i) [redacted]. These forecasts are in line with Treasury's inflation forecasts. 9(2)(b)(ii) [redacted]. Given the Government announced through Budget 2024 that the annual maximum fee movement for 2025 will be 6.0 percent (subject to consultation with the sector), there is upside in fee revenue for 2025 if ITPs increase fee levels by the maximum amount and domestic forecasts are achieved (we estimate a positive impact of around $10 million).

- Personnel and other expenses are assumed to increase in line with inflation over the 2025 to 2028 period. We consider this a broadly reasonable assumption although many TEIs have previously assumed personnel costs increase by inflation plus an additional increase for promotions. It also does not include the implementation of any unplanned cost-reduction initiatives. Such initiatives would potentially lower expenditure over the medium-term (but come at a cost in the short-term).

18. Overall, we consider these assumptions are broadly reasonable with some upside and downside risk, although probably greater downside risk. These risks are no different to the risks which exist for the entire tertiary sector.

…and the forecasts include costs being reallocated out to each ITP from national office…

19. The forecasts assume from 2025 that all relevant expenditure incurred by Te Pūkenga's head office is allocated back to the former ITPs. 9(2)(b)(ii), 9(2)(f)(iv), 9(2)(i) [redacted]

20. There are a range of additional operating and capability costs that have also been added into the forecasts. Some of these activities had previously been covered by Te Pūkenga's head office (e.g. finance, property, HR, digital, legal, marketing) while others relate to the additional capability needed if ITPs are re-established on a standalone basis (e.g. executive and senior management costs, board costs, international recruitment/marketing) These costs were estimated alongside advice from the specialist advisors. 9(2)(b)(ii), 9(2)(i) [redacted]

21. In total, reallocating the costs from national office out to the individual ITPs and accounting for the additional capability needed to be standalone, results in additional expenditure of $74 million in 2025, rising to $84 million in 2028. This almost entirely offsets the financial gains from the modelled return to SAC funding rates (which is forecast to generate an additional $77 million in revenue in 2025).

…but we consider the domestic enrolment forecasts are overly optimistic…

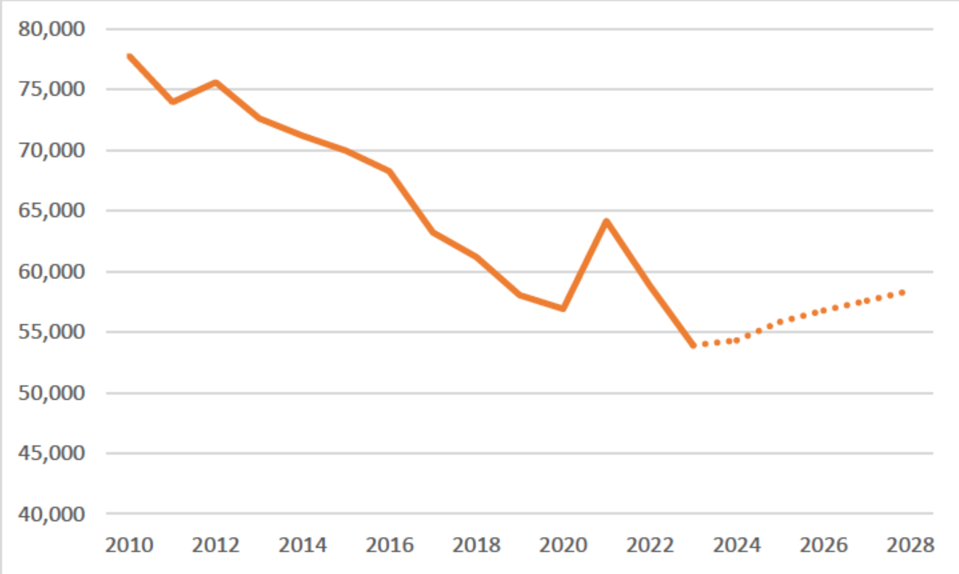
22. The key driver of improving financial performance over the next five years is through increased domestic and international enrolments. Over the forecast period, domestic EFTS across the ITP sector are forecast to increase by 8 percent while full-fee international enrolments are expected to increase by 66 percent.

23. Every ITP has assumed domestic enrolments rise every year from 2024 to 2028. The forecasts range from 9(2)(b)(ii) [redacted] (NorthTec, Wintec, Toi Ohomai, and TPP) to 9(2)(b)(ii) [redacted] at SIT. SIT's forecasts are equivalent to domestic enrolment growth of 9(2)(b)(ii) [redacted] for four years. The enrolment forecasts were developed by the specialist advisors alongside each business division.

24. Historically, domestic EFTS in the ITP sector have closely followed the overall unemployment rate. As job prospects decline, more people choose to study, whereas if there are plentiful employment opportunities, less people choose to enter the ITP sector. The increase in the unemployment rate over 2024 has helped support a small increase in domestic EFTS, and with the unemployment rate expected to increase further in 2025, this may support ongoing domestic enrolment growth in that year.

25. However, the unemployment rate is then expected to fall over the 2026 to 2028 period which would suggest a decline in overall domestic enrolments across the sector. This view is also supported by the Ministry of Education's 2024 BEFU forecast which shows domestic enrolment growth in the ITP sector in 2025, before declining over the 2026 to 2028 period. This reflects changes in the tertiary-aged population and improving economic conditions over the forecast period.

Figure 1: Historical domestic EFTS in the ITP sector and forecasts 2024 to 2028



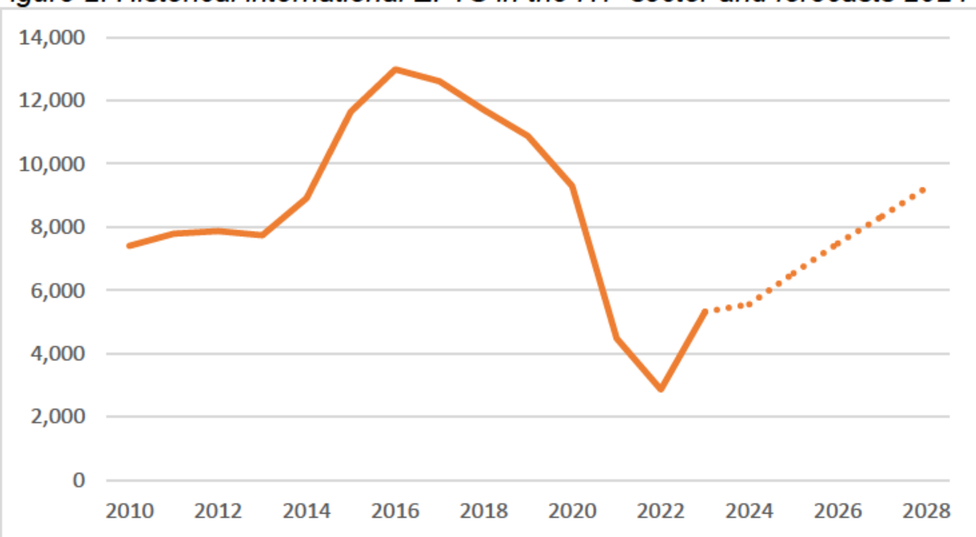
26. As shown in *Figure 1*, domestic EFTS in the ITP sector have also been gradually trending down over the past decade and were 31 percent lower in 2023 than they were in 2010. These declines predated the establishment of Te Pūkenga. There have been various reasons for this decline, but it includes more learners choosing to go to university or private training establishments (PTEs). To achieve the domestic enrolment growth forecasts over the 2024 to 2028 period will require the ITP sector to not only break the relationship between domestic enrolments and the unemployment rate, but also likely need to see them recover market share from the university and PTE sector. In our view, there is no foreseeable reason for why this would occur.

27. There is a key risk that the domestic enrolment growth forecasts are not achieved, particularly for every ITP, which would result in lower revenue forecasts and financial performance being worse than expected. There has been no downside sensitivity analysis completed by Te Pūkenga.

…and there is a risk that international enrolment growth forecasts are not achieved…

28. Across the ITP sector, full-fee international EFTS are forecast to increase by 66 percent between 2024 and 2028 so that enrolments return to 2020 levels. Forecasts range from 9(2)(b)(ii) [redacted] at NorthTec to 9(2)(b)(ii) [redacted] growth at SIT. Wintec and NMIT are also expecting to 9(2)(b)(ii) [redacted] this period. SIT has the most optimistic enrolment forecasts for both domestic and international learners, helping it forecast a small surplus in 2027.

Figure 2: Historical international EFTS in the ITP sector and forecasts 2024 to 2028



29. As we have previously advised, Te Pūkenga significantly increased international fee levels in 2024. Most ITPs have assumed the higher fees levels are retained. Some ITPs however (e.g. SIT and Otago) have assumed some fee discounting to boost volume. If entities return to being standalone, we would anticipate a significant amount of competition for international students which may negatively impact on revenue.

30. At a sector level, full-fee international enrolments are forecast to increase by 9(2)(b)(ii) [redacted] in 2024. To achieve the forecast growth rates over the remainder of the forecast period would require a considerable increase in the speed of the recovery. While possible, there is a key risk that the forecast growth rates are not achieved and overall financial performance is worse than expected.

31. We also consider the modelling understates the agent fees that are required to achieve this level of full-fee international enrolment growth. Instead of being modelled alongside the growth in full-fee international enrolments, it has been pro-rated on total EFTS. This therefore overstates the profitability gains that are being made from increased international enrolment numbers, particularly for those with 9(2)(b)(ii) [redacted] As with domestic enrolments, there has been no downside sensitivity analysis completed.

9(2)(b)(ii), 9(2)(f)(iv), 9(2)(i)

[redacted]

…but the forecasts assume almost no cost-out is undertaken

35. While we consider there are several elements of the forecasts that are optimistic, particularly enrolment growth forecasts, it should also be noted that no comprehensive cost-out activity has been included in the forecasts. While the specialist advisors were tasked to identify such initiatives, none were forthcoming as part of the forecasting process.

36. An aggressive cost reduction approach or change in operating model would potentially support an improvement in profitability in the medium-term. However, it would come at a cost in the short-term, which would worsen profitability (no restructuring or transformation costs are included in the forecasts), and there is also a risk it would negatively impact enrolments and revenue over the medium-term. This is discussed later in the paper.

Changes required to move to sustainability

The ITP sector faces longstanding financial issues…

37. The ITP sector has been facing financial difficulties for nearly a decade. This has been due to a range of reasons including falling domestic and international enrolments, minimal increases in tuition subsidy rates, high inflation, and a failure by many to right size their cost base to lower enrolments. Some ITPs have also made poor investment decisions which has lowered available cash (or increased debt) and increased ongoing operating costs.

38. These issues existed prior to the establishment of Te Pūkenga. Between 2016 and 2018, the Crown formally intervened in three ITPs due to financial issues and around $90 million in Crown capital injections and loans were provided to these ITPs to ensure they could meet their operating commitments. These financial sustainability issues have not been addressed or improved under Te Pūkenga including those that were deemed critical (e.g. TPP).

…which are forecast to continue over coming years…

39. The latest forecasts reinforce the financial challenges facing the sector, and that these are expected to continue over the next four years. Only five ITPs are expected to report a surplus by 2028 (and one a breakeven result), and this is reliant on optimistic enrolment and financial forecasts being achieved. There is a key risk that enrolment levels are lower than forecast, and fewer ITPs reach a surplus position by 2028, resulting in a very high financial risk to the Crown.

…and significant reductions in expenditure are needed…

40. We have continually advised that there is an urgent need for all ITPs to make significant cost saving efforts in an attempt to become financially sustainable and lower current operating deficits. However, for many, this requires addressing some longstanding and fundamental issues with their delivery and operating models rather than simply adjusting expenditure. Such changes are of a wholesale nature, take time to deliver, and are complex to implement. These have not been able to be achieved historically.

41. Given the cost structure of ITPs and their limited ability to increase revenue beyond international enrolment growth, the most efficient way to increase profitability is through reducing operating and personnel costs. Most ITPs, however, have been 'trimming' operating costs for a long period of time and under their current operating models, there is likely only minor further gains that can be made in this area. In the short-term, the most effective way to reduce costs is through reducing staff numbers. To provide an indication of the depth of cuts required, we have modelled the level of staffing reductions that would be required over the next 18 months to return each ITP to a 3 percent surplus in 2026 (see *Table 2*).

9(2)(f)(iv)
[redacted]

43. There are also considerable change/redundancy costs associated with reducing staffing levels. 9(2)(f)(iv) [redacted] These changes would need to be funded from Te Pūkenga's cash reserves as part of re-establishing individual entities.

9(2)(f)(iv)

[redacted]

…with the level of staffing reductions required likely unachievable…

44. We consider most ITPs would be unable to achieve such a large FTE reduction without resulting in considerable negative revenue impacts. To achieve this level of staffing cuts, the former ITPs would need to implement large scale reductions in programme offerings and services. Some of these savings would be achieved by focussing on programmes that have low enrolments and/or achieving poor contribution margins.

45. However, while reducing the number of programmes being offered will reduce costs, it will also reduce enrolments and revenue and have an unknown impact on overall profitability (the exception being if the programme is genuinely loss-making versus just being sub-economic). Furthermore, because there are a wide range of fixed costs to run an ITP, it puts more pressure on the remaining programmes which must now deliver an even bigger contribution margin. There is also a tension of ensuring ITPs maintain the appropriate capability to be able to deliver on their expected future demand forecasts.

46. In our view, wholesale staffing cuts (particularly if they are not related to a strategic plan) can easily lead to a downward spiral where reductions in expenditure continue to be needed in response to falling revenue from the previous round of cuts. This has been the experience in WelTec and Whitireia since it entered financial difficulties in 2018.

…and more fundamental changes are required…

47. For a few ITPs, implementing cost-saving initiatives and reviewing how and what they deliver to learners is likely put them on a pathway to viability. However, for the majority of ITPs that have more critical and longstanding financial issues, we consider more wholesale change will be required. A traditional cost-cutting exercise within the bounds of the same operating and delivery model will not result in sustainable operations.

48. In the absence of greater Crown funding, these institutions require fundamental changes to their operating and delivery models. However, there is considerable uncertainty around the effectiveness of such models and whether they will result in financial sustainability. Furthermore, transitioning to these new models, particularly where they require large changes in property footprints, will likely take time and funding to implement.

…with the changes needing to be guided by a vision for each region's delivery…

49. For those ITPs that require fundamental change, we consider that undertaking aggressive cost-cutting without a detailed understanding of the issues at each ITP and without a clear vision for the future of delivery in that region will likely result in ongoing financial issues. Given your intention to re-establish independent ITPs, whether on a standalone basis or as part of the federation model, we recommend the following approach is taken to support the financial sustainability of those ITP that are facing considerable challenges:

- confirm the financial position of each ITP (including undertaking downside sensitivity analysis), understand the profitability of programmes and delivery sites, and the utilisation of assets.
- confirm what academic delivery should be delivered in each region and in what mode taking into account financial performance, learner demand, stakeholder views, and other tertiary delivery that occurs. It should also identify what impacts these changes will have for learners (on both learner success and access), regions, and the national network of provision.
- decide what operating model is needed to achieve the required delivery, including staffing levels.
- decide what property is required to deliver the required operating model and delivery and divest from unneeded assets.
- develop a detailed plan on transitioning to the new operating and delivery model, including identifying what capability is needed to deliver on the plan.
- execute the plan.

50. This approach effectively builds a bottom-up view of the staffing capacity and capability required and which capital assets would be needed to maintain delivery of profitable programmes based on stakeholder views. Once a base level of profitability is established, decisions could then be made around what loss-making provision is critical to a particular region and the national network of provision, and whether this could be cross subsidised by the profitable delivery. Surplus assets (if any) could then be realised with the proceeds reinvested into the tertiary system.

51. While further advice will be needed, we consider the planning stage (the process outlined in paragraph 49) is likely to take several months at a minimum, although likely longer. However, this work can start almost immediately. Once a detailed plan is in place for each region that needs it, execution of the plan could take several years depending on the level of change proposed. While staffing and operating changes can be made relatively quickly, transitioning to completely new delivery models and divesting from assets is likely to take several years. Some tough decisions will need to be made around what future delivery looks like in each region. These ITPs will need funding to both support the changes and cover the ongoing deficits while change is underway.

52. There is also no guarantee that such changes will result in financially sustainable operations as some previous downsizing approaches (e.g. WelTec/Whitireia or TPP) have not resulted in financially sustainable entities. In other cases, the changes undertaken may to reduce the size of the deficit, but not return ITPs to a surplus position. In such scenarios, careful consideration will need be given to next steps.

…and it is likely specialist help will be needed to support the proposed changes…

53. Te Pūkenga has indicated it is beginning to look at the types of changes that would be required to address long-term financial sustainability concerns. However, given the capacity constraints within Te Pūkenga, it is likely external resource will be needed to undertake the work in a timely manner.

9(2)(g)(i) [redacted]

55. Although Te Pūkenga has been co-operative, we intend to use section 332 of the Education and Training Act 2020, which allows the chief executive of the TEC to require Te Pūkenga (or a subsidiary of Te Pūkenga) to obtain specialist help if it believes the entity may be at risk, to ensure the right capability and capacity is in place and that the work occurs as a matter of priority. The notice allows us to state the person or organisation from which help is to be obtained.

…but careful monitoring of learner success and the network of provision will be needed

56. The scale of change required for some ITPs 9(2)(b)(ii) [redacted] is likely to mean that fewer programmes are offered (particularly face to face), there are fewer delivery sites, and greater levels of vocational education and training are picked up by other parts of the tertiary sector.

57. The TEC we will need to carefully identify and monitor the impacts on learner success and access. Moving to a greater proportion of online/blended delivery is likely to negatively impact learner outcomes while closing delivery sites will have an impact on access for some learners. Such changes are likely to impact those learners who are typically more disadvantaged.

58. We will also need to carefully monitor any impacts on the network of provision. Given nearly all ITPs need to make changes to their programme offering to support financial sustainability, there is a possibility that similar areas of study are cut across the country due to being unprofitable. While some such provision may be picked up by the PTE sector, there is a risk some provision would not be able to be delivered.

Establishment of new ITP subsidiaries

9(2)(f)(iv), 9(2)(b)(ii) [redacted]

61. 9(2)(b)(ii), 9(2)(f)(iv) [redacted]. Given we consider the forecasts are optimistic and reliant on ongoing enrolment growth, there is a risk that performance is worse than forecast. Ongoing funding of these deficits will be required. Combining seven loss making entities with Open Polytechnic, without a clear path to profitability, places significant financial risk on the Crown and will need to be very carefully managed.

…which will cause issues under the Companies Act 1993…

62. A subsidiary that is established by Te Pūkenga is subject to the Companies Act 1993. Under the Companies Act, directors must not carry on business in a manner likely to create a substantial risk of serious loss to creditors and must not agree to obligations without reasonable grounds for believing that the company will be able to perform those obligations when due. Directors who breach that duty are liable to pay compensation for any losses incurred by company creditors, in the event of a failure.

63. Given the financial challenges facing nearly all ITPs, it will be essential for each subsidiary to be solvent when established and able to meet its financial obligations as they become due. If not, we consider it will likely be impossible to appoint professional directors to govern the new entities. There are several ways to ensure solvency:

- only establish subsidiaries if there is clear evidence that it can operate in a financially sustainable manner and provide sufficient working capital to ensure it has liquid assets to meet obligations as they fall due. The exact amount of working capital will vary between ITPs, but we would anticipate current ringfenced reserves would be utilised for this purpose.
- each subsidiary is given a guarantee under the Public Finance Act (i.e. a letter of comfort).
- the Government provides upfront capital injections for each subsidiary.

64. Providing each subsidiary with a letter of comfort from the Crown would require approval from the Minister of Finance. 9(2)(f)(iv) [redacted]

65. Alternatively, the Government could recapitalise each entity on establishment to ensure solvency. While Te Pūkenga's cash reserves can be used to support this process, we do not consider these will be sufficient. Additionally, there is the 9(2)(b)(ii) [redacted] contingency established through Budget 2024 that could be used for this purpose. However, further work is needed to establish exactly how much funding would be required to support the recapitalisation. This is discussed in the next section.

…and we consider it will be difficult to find directors to go on the new boards…

66. Overall, given the financial challenges facing the sector, we consider attracting directors for almost all ITPs will be difficult, especially without a letter of comfort from the Crown. Even with a letter of comfort, it will be difficult to find directors with the right experience and skillset in such a short timeframe. While subsidiary boards can be any size, which would lower the number of appointments that need to be made, this would need to be balanced against the need for appropriate capacity and capability at a governance level to make significant decisions around returning the institutions to sustainability.

67. Te Pūkenga will be responsible for finding directors of subsidiaries and will need to run a large process to find appropriate individuals. This will likely involve bringing in capability to assist. This will also encounter the issues we have raised previously (AM-24-00255 refers), where the subsidiary board members are likely to not be the same appointments you wish to make for the inaugural councils (unless such an issue was addressed in any urgent legislation).

…while Te Pūkenga would need to undertake a range of work to prepare for the transition…

68. Assuming any urgent legislation accounts for the transition of assets, liabilities, and staff to the new subsidiaries, there is still a considerable amount of work for Te Pūkenga to do to identify which assets, liabilities, and staff transfer to which new subsidiary. There is a risk that Te Pūkenga does not have sufficient time or capacity to undertake this exercise and work through difficult decisions. In particular, it will be difficult to make decisions regarding how much cash is provided to each subsidiary from Te Pūkenga's cash reserves (excluding ringfenced reserves). 9(2)(g)(i) [redacted]

9(2)(f)(iv) [redacted]**…**

69. 9(2)(f)(iv) [redacted]. For many of these entities, a significant amount of cash will be required to both cover the operating deficits and to fund the required change. As noted earlier, we consider specialist capability will be needed to support this work to be undertaken.

9(2)(f)(iv), 9(2)(g)(i) [redacted]

…but the pathway to sustainability is much more uncertain for others

74. We consider more detailed analysis for each ITP is required to assess and identify the potential pathway back to viability, over what timeframes, and what is achievable. 9(2)(b)(ii) [redacted]

9(2)(b)(ii) [redacted], there are significant viability issues that will take several years to address, if they can be at all. While financial forecasts for a federated model have not been prepared, we consider it will be highly unlikely that Open Polytechnic would be able to generate sufficient surpluses to offset the large deficits that are forecast for the remaining ITPs of the federation, particularly in the short-term. 9(2)(f)(iv), 9(2)(g)(i) [redacted]

Recapitalisation needs and the pressure that is expected to be placed on Te Pūkenga's balance sheet

The establishment of subsidiaries and independent entities will require recapitalisation…

75. The re-establishment of individual ITPs (firstly as subsidiaries and then as independent entities) will require nearly all ITPs to be recapitalised to ensure they have sufficient financial resources to meet their obligations as they fall due. Further modelling and analysis will be needed to determine the exact level of recapitalisation required. This will need to be done in conjunction with Te Pūkenga and when there is more certainty on the future structure, transition process, and timing. However, in our view, the recapitalisation will ideally need to provide for:

- initial working capital
- any liabilities that are transferred to the new entities
- committed capital/IT costs and deferred capital/IT expenditure
- operating deficits for a set period of time to allow changes to be made to improve financial sustainability
- any transition and transformation costs to a new operating model (e.g. redundancy costs)
- Crown loan repayments ($23 million for Unitec, $18 million for Otago, and $4 million for UCOL)

…which will need to be funded by Te Pūkenga, the Crown, and asset sales

76. There are several sources of funding that can be used to support the recapitalisation of individual entities:

- *Ringfenced reserves* – at the end of 2023, Te Pūkenga had $113 million of ring-fenced reserves with $88 million across the former ITPs (although some of this relates to Ara's insurance settlement rather than strictly being 'ringfenced' reserves) and $25 million across the former ITOs. The breakdown for the former ITPs is: $54 million for Ara, $12 million for SIT, $12 million for EIT, $9 million for NMIT and $0.3 million for TPP.
- *Te Pūkenga cash reserves* – Te Pūkenga is forecasting to have 9(2)(b)(ii) [redacted] in cash at the end of 2024. This includes ring-fenced reserves which takes the non-ringfenced reserves total to around 9(2)(b)(ii) [redacted]. While the majority of this has been generated by WBL, Te Pūkenga is a single legal entity and can redistribute funds across the group, although this would likely be met by some resistance by WBL and industry. These funds will need to be allocated across both re-established ITPs and the future work-based learning arrangements, while Te Pūkenga will need to retain some funds as part of winding-up the institution.
- *The Budget 2024 contingency* – a 9(2)(b)(ii) [redacted] contingency was established through Budget 2024 to meet all of the costs of establishing and transitioning to the new VET system. This amount, however, includes any agency costs and the establishment and transition to a federated model.

- *Asset sales* – Te Pūkenga has initially assessed that around $131 million can be realised through land and building asset sales that are surplus to delivery needs across the former ITP network through to 2031. This is a high-level estimate and more detailed work would need to be undertaken by Te Pūkenga to validate these assumptions and seek further opportunities for divestment of under-utilised assets (including for example where fundamental operating model changes are made that free up further assets for disposal). It will take some time to generate cash from such sales so specific ITPs may need additional funds before the sale process can be completed. It does, however, provide another avenue to support recapitalisation over the medium-term.

77. Further work will be needed to establish whether there are sufficient funds from the above sources to recapitalise the new ITPs, whether it will cover all of the recapitalisation needs, and for how long. 9(2)(f)(iv), 9(2)(g)(i) [redacted] There is a key risk to the Crown that further funding will be required, either on re-establishment or in the medium-term to cover ongoing deficits, capital needs, or transformation requirements. 9(2)(g)(i) [redacted].

78. Determining recapitalisation requirements will also be made more difficult by taking a phased approach where there is ongoing uncertainty about which entities will be established when and how long Te Pūkenga will remain in existence. If profitable entities are made standalone ITPs and they take their ring-fenced reserves with them (and are provided with additional working capital), this will leave Te Pūkenga with a highly unprofitable entity with depleted cash reserves.

Next steps

79. We would like to discuss this paper with you at your earliest convenience.

80. We also recommend that this paper is forwarded to the Minister of Finance for her information.

Tim Fowler

Chief Executive

Tertiary Education Commission

11 June 2024

Hon Penny Simmonds

Minister for Tertiary Education and Skills

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