NHS
MEL(1993)162

Folder

THE SCOTTISH OFFICE

National Health Service in Scotland
Management Executive

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Dear Colleague

PRIVATE FINANCE: LEASING: JOINT VENTURES: DELEGATED LIMITS

Summary

1. Further to NHS MEL (1993)26, this letter supplies General Managers and NHS Trust Chief Executives with HM Treasury guidance on Leasing and Joint Ventures involving the use of Private Finance and with guidance on the appraisal of private finance schemes providing services to the NHS. This letter also informs of delegated levels of authority and sampling procedures for projects involving Private Finance.

2. The HM Treasury guidance and details of the delegated levels of authority and sampling procedures have been reproduced in 4 parts to this letter as follows:

* **Part A:** Leasing Guidance
* **Part B:** Joint Venture Guidance
* **Part C:** Guidance on Appraisal of Private Finance Schemes Providing Services to the NHS
* **Part D:** Delegated Levels of Authority and Sampling

Action

3. Health bodies are asked to note the guidance on Leasing and the criteria applied.

4. Health bodies are asked to note the guidance on Joint Ventures.

5. All schemes involving the use of private finance must be subject to option appraisal irrespective of the limit of delegation a body may have.

6. To help maintain good standards in option appraisal and to see as wide a range as possible of the type of scheme being considered, sampling of approved options will be done by the Management Executive and HM Treasury. Details of this are set out in Part C to this letter.

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7. Enquiries relating to any of the guidance attached should be made to the Management Executive.

M H COLLIER
Director of Finance

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PART A

GUIDANCE ON LEASING

Overview

"Private Finance: Guidance for Departments" issued with NHS MEL (1993)26 dealt with leasing of assets. Where the great majority of risk stays with the private sector, the capital value of a leased asset will not count against a health body's allocation or EFL. The attached guidance sets out the criteria for assessing the transfer of risk. For assets with a fair value under £1 million, these will not count against provision totals if they meet the SSAP21 definition as an operating lease.

For assets between £1 million and £10 million, it is assumed that there is sufficient risk transfer when the present value of the minimum lease payment does not exceed 70% of the fair value of the assets. In other cases (and all leases of assets with a fair value over £10 million) a detailed assessment of risk transfer will be required.

Before any lease is entered into it must be shown to offer best value for money in comparison with purchase. Normally appraisals should include alternative lease options to ensure best value for money is obtained. Option appraisals should used discounted cash flow calculations using the current interest rates charged by the National Loans Fund for the period equivalent to the life of the lease, plus 2 per cent. Details of current rates can be obtained from the Management Executive.

The Guidance also includes sections on value for money, taxation criterion and the Public Supply Contract Regulations 1990.

PART B

GUIDANCE ON JOINT VENTURES

Overview

The Guidance includes sections on:

* types of joint venture;
* appraisal;
* the competitive process; and
* technical points which may arise.

The guidance is intended as preliminary and will be developed in the light of experience and it is therefore not possible to cover all issues which may arise. In cases of uncertainty, the Management Executive should be consulted.

Throughout the Guidance reference is made to the "Green Book". This is reference to "Economic Appraisal in Central Government: A Technical guide for Government Departments", HMSO 1991.

PART C

GUIDANCE ON THE APPRAISAL OF PRIVATE FINANCE SCHEMES PROVIDING SERVICES TO THE NHS

Introduction

1. Private Finance schemes offer opportunities to the health service to take advantage of private sector efficiencies in providing services and, subject to certain criteria, offer the further advantage of access to additional resources. For many years the public sector has contracted with the private sector for the provision of a wide range of services. The Private Finance Initiative represents a change in emphasis recognising that there should be no impediment to extening the involvement of the Private Sector to cover areas previously regarded as the preserve of the public sector where this is sensible from an economic and practical point of view.

2. Following the initial announcement of the Private Finance Initiative the Treasury have issued guidance on a number of areas in the following documents:

- Guidance on Private Finance, published by HM Treasury on 9 December 1992 and circulated with MEL(1993)62

- Joint Ventures: Guidance for Departments, published by HM Treasury on 16 March 1993 and circulated with MEL(1993)[ ]

- Private Finance: Leasing Guidance, published by HM Treasury on 26 May 1993. Although primarily about leases, this covers aspects of appraisal, especially risk assessment, which apply equally to other Private Finance schemes. Circulated with MEL(1993).

3. This guidance, which should be read in conjunction with these documents, is intended to assist in the application of Private Finance objectives in the area of contracting with the private sector for the provision of services. In particular it is concerned with services which may require to use significant capital assets for their delivery. Historically such services have been provided to the health service by operation of their owned capital plant.

4. It should be noted that the guidance in this note is preliminary and will be developed in the light of experience.

Criteria for the Choice of Private Finance Schemes

5. The choice of which projects might be most suitable for private sector involvement will depend inter-alia on:-

- the size of the project: larger projects are more likely to be of interest to the private sector, although the involvement of the private sector is encouraged in projects of all sizes.

- the objectives of the project: it is more likely that need in principle can be established where there are statutory obligations to be met.

- the market circumstances of the project: as discussed below, Private Finance schemes should involve risk transfer such that the private sector bears as large a part of the risk as is appropriate. Projects in areas where there is scope for alternative purchasers for the service and/or which do not represent the only supply of the service in the local area would represent ideal Private Finance schemes from the point of view of potential for risk transfer, although any project might be selected if it is felt that value for money might eventually be justified.

The Role of the Private Sector

6. There are a number of reasons why health bodies might wish to involve the private sector in projects. Apart from the obvious attraction of drawing on an additional source of funds, the introduction of private sector management skills and the sharing of risks with the private sector should lead generally to better value for money through shorter construction times, better control of project costs, and reduced operating and maintenance costs. A cooperative approach may also lead to economies of scale through other non-NHS use of a facility.

7. The characteristics of the market are also important and potential service providers will wish to consider the wider market for the services in question. It is likely that risk transfer will be more easily facilitated in a case where there are alternative purchasers of the service, because there is likely to be a re-sale market for the asset at the end of the contract period. Conversely, there may be circumstances where the health body may now, or in the future, have a choice of private sector service providers in a particular area. Again it is likely that the cost to the health bodies will be reduced when there is competition in supply between providers. These considerations are important criteria in determining the potential role of the private sector and in the appraisal of a particular proposal, in particular the question of risk transfer. In the absence of suitable market conditions value for money will be harder to establish but it may still be possible and no scheme need be ruled out for detailed appraisal.

8. Health bodies will wish to invite a range of private sector bidders to provide the service. A clear specification of the requirements, performance standards, etc is required as this will enable the invitation to tender and subsequently a binding contract to be drawn up. Procurement procedures, similar to those used for competitive tendering will be appropriate and, where applicable, EC procurement procedures should be followed.

9. Control of the assets involved will remain with the private sector provider. Close attention will therefore have to be given to appropriate contractual terms, which on the one hand ensure that risk is properly placed with the private sector and on the other that the health body's position is protected in the event of contractual difficulties.

Public Sector Options

10. It is necessary to consider whether the need can be met by health body capital expenditure within an acceptable timescale. If these conditions are satisfied the appraisal must clearly identify the cost of public sector means of meeting the specified objectives. The public

sector comparator should not be modified in the light of private sector proposals; ie there should be no "cherry picking" of innovative ideas from private sector submissions or tenders in order to reduce the costs of the public sector scheme.

Option Appraisal and the Transfer of Risk

11. In considering options the appraisal should compare private sector bids with the cost of public sector provision, unless public sector provision is not realistic on a similar timescale. The choice of option should be based on a full and proper assessment of the costs and benefits of each.

12. The option appraisal would include a full consideration of all the costs, running costs as well as capital, of each, employing a Discounted Cash Flow methodology using **a 6% real rate of return** or the appropriate discount rate as outlined in the leasing guidance based on the proposed term of the initial contract with private sector providers. Where appropriate, qualitative, but preferably quantitative, assessment of the benefits of the options should be used. The assessment should be based on the health body's best estimates of items such as capital and operating costs, usage and demand etc. However it is essential that the health body's own provision option or options give full and serious consideration to the risks attaching to the particular project, most probably in the form of sensitivity analysis. Health Bodies should ensure that the criteria on which any particular option is chosen are set out explicitly.

13. Broadly speaking, the extent of risk transfer to the private sector is a key factor in assessing value for money and it should be properly appraised. The relevant criterion is that contracts should be on a commercial basis and not involve dependence on the public sector as a purchaser for the lifetime of the facility or the public sector underwriting supply to other customers. The initial contract should not be for the full design life of any assets required for the provision of the service. The full value of assets should not be recoupable by the private sector company within the period of the initial contract. In providing for risk transfer the health body will wish to ensure that payments made for services provided under the contract are dependent on the satisfactory delivery of the service according to the requirements set out in the contract. The private sector should also accept the risk of usage varying around a predetermined level. Payment would be made for service provided, for example in the clinical waste context this might be by weight of material to be disposed of or another such appropriate parameter. Any minimum "guaranteed payment", which it is accepted may be necessary, should be related to a predetermined level below that which the authority expects to require for most of the contract period. More wide ranging guarantees or indemnities to the operator in relation to the level of service provided should be avoided.

14. The Treasury guidance note on leasing also provides a note on the issue of the evaluation of risk. A typology of different types of risk is

- demand risk - risk that arises as a result of uncertainty as to the extent to which the services provided by the project will be required in the future;

- operating risk - which arises as a result of the cost of running the equipment, including the need to meet predetermined environmental standards, not being known;

- construction cost risk - which results if construction and set up costs are not known in advance;

- obsolescence risk - this relates particularly to situations where technology is changing rapidly and as a result the asset is out of date before the end of the contract period;

- resale risk (on completion of a contract shorter than the asset life) - this relates to doubt about the resale value or alternative use of the asset at the end of the contract period;

- regulatory risk - which relates to the possibility of the Government changing the regulatory regime during the contract period eg in relation to clinical waste, introducing more stringent environmental controls.

15. Some risks are best borne by the private sector. In general the party most able to influence the events which create risk is the one who should bear that risk. For example if the private sector is the operator of a plant, then they should be liable to the risk of operating failure. All the above, with the possible exception of regulatory risk, should predominantly be borne by the private sector.

16. The private sector will charge a premium for taking on risk, as noted above. The substance of the value for money test of private finance schemes is whether this is a fair and reasonable charge. Where such risk premium is assessed as being at an additional cost to the risk being carried by the public sector, the additional cost should be justified in terms of the expected efficiency gains.

17. Guidance on the issue of tax concessions and the appropriate discount rate methodology for the comparison of private sector alternatives is provided in the Treasury "Green Book" on economic appraisal*.

Further Advice

18. Further advice on appraisal methodology can be obtained from Alasdair Munro (Room 254B, St Andrew's House, Tel: 031-244 2534).

National Health Service in Scotland
Management Executive
December 1993

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*"Economic Appraisal in Central Government: A Technical Guide for Government Departments" HM Treasury 1991 HMSO.

PART D

DELEGATED LEVELS OF AUTHORITY AND SAMPLING

The Management Executive have been given authority to approve schemes which include a capital component of up to £10 million. Subject to prior approval of a sample of project above £4 million and to subsequent review of a sample of projects below this limit by HM Treasury.

For health bodies in Scotland, the limit which can be delegated is now between £250,000 and an upper limit of £1 million. The determination of individual limits of delegation is dependant on 3 main elements. These are:-

* the body's ability to demonstrate good standards of option appraisal;
* the business turnover of the body;
* the number and size of projects being considered.

Increases in delegated limits are as follows:

Delegated Limit	Health Body
Projects up to £1 million	Argyll and Clyde Health Board Fife Health Board Forth Valley Health Board Grampian Health Board Greater Glasgow Health Board Highland Health Board Lanarkshire Health Board Tayside Health Board Aberdeen Royal Hospitals NHS Trust Grampian Healthcare NHS Trust Dundee Teaching Hospitals NHS Trust
Projects up to £600,000	Ayrshire and Arran Health Board Borders Health Board Dumfries and Galloway Health Board Lothian Health Board Ayrshire and Arran Community NHS Trust Monklands and Bellshill NHS Trust North Ayrshire and Arran NHS Trust Raigmore Hospital NHS Trust Royal Alexandra Hospital NHS Trust South Ayr Hospitals NHS Trust Stirling Royal Infirmary NHS Trust Victoria Infirmary NHS Trust West Lothian NHS Trust Yorkhill Hospitals NHS Trust

The current limit of delegation of £250,000 remains in force for all other health bodies.

Any further increases to authorised levels of delegation will be notified to the respective health body direct.

Approval of schemes outwith a body's delegated limit will be by the Management Executive and perhaps by HM Treasury. All such schemes should be sent to the Management Executive in the first instance who will, where necessary, refer on to HM Treasury.

The approval of innovative or novel schemes remains the authority of HM Treasury and all schemes of this nature should be referred to the Management Executive in the first instance.

Capital Value of Project	Action
Within Health Body Delegated Limit	
≤£250,000	Health body to maintain good standards of option appraisal and option appraise each project.
>£250,000 and ≤delegated limit	Retrospective sampling of health body approved options by the ME.
Outwith Health Body Delegated Limit	
>delegated limit and ≤£1 million	All projects to be approved by the ME.
>£1 million and ≤£4 million	All projects to be approved by the ME. List of approved projects compiled by ME on bi-annual basis for retrospective sampling by HM Treasury.
>£4 million and ≤£10 million	All projects to be approved by the ME. HM Treasury to sample 50% of all projects for approval. Reduction of the sampling rate to be linked to good standards of option appraisal.
>£10 million	All projects require ME and HM Treasury approval.