THE SCOTTISH OFFICE

NHS
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National Health Service in Scotland
Management Executive

St. Andrew's House
Edinburgh EH1 3DG

4 March 1993

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General Managers,
Common Services Agency
General Manager,
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General Manager, State
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Chief Executives, and
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For information:

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Dear Colleague

PRIVATE FINANCE

Summary

1. This letter informs General Managers and Directors of Finance of the changes in the approval criteria for the use of Private Finance (formerly Unconventional Finance) as announced in the Chancellor of the Exchequer's Autumn Statement. The changes represent a significant Government-wide initiative and managers should be receptive to worthwhile and innovative new schemes.

2. Following the measures announced by the Chancellor in his Autumn Statement on 12 November there will now be more opportunity to use private capital in the public sector. The Financial Secretary to the Treasury is giving particular encouragement to this initiative, and the Treasury have published the interim guidance issued to Departments about the private finance initiative, a copy of which is attached. Further guidance on the use of private finance will be issued later but, in the interim, your attention is drawn to the changes in the approval criteria.

3. The additional scope for using private capital in the NHS will mean additional resources for health care. The aim for us is to ensure that the NHS uses the new arrangements to benefit patients through improved services to patients or greater efficiency in providing support services.

4. Existing circulars relating to delegated limits remain extant at this time, however the possibility of increasing these delegations is to be discussed with the Treasury.

Action

5. Your attention is drawn to the revised guidance on private finance, attached to this letter.

6. The revised procedures offer considerable scope for the use of private finance in a wide range of projects where there are cost savings or where additional costs can be justified in terms of enhanced services or transfer of risk to the private sector. Health bodies are encouraged to consider private finance projects and should take account of the new guidelines when appraising such projects and in referring those requiring ME approval. The examples supplied in Appendix 1 to this letter are not exhaustive and there may be many other ways to encourage private sector capital in the NHS. The ME and Treasury are open to further developments and are keen to consider new proposals which make good use of NHS resources and as in the past, it is helpful if you keep the ME informed of proposed developments at an early stage.

7. This letter should be copied to Unit Genernal Managers for information.

M H COLLIER
Director of Finance, NHS in Scotland

APPENDIX 1

The Chancellor's Statement affects 4 main areas in privately financed schemes and the impact of each of these for the NHS is set out in the following sub-paragraphs.

Financially Free-Standing Projects

These are private sector projects which are supported by charges to the end user. Such projects are unlikely to be applicable to the NHS.

Joint Ventures

The private sector is to be actively encouraged to take the lead in joint ventures with the public sector. Projects will be assessed for viability after taking account of the public sector contribution. The NHS will have to demonstrate value for money for its own contribution to the joint venture.

In developing joint venture proposals it is important to have competition for the private sector contribution and for risks to be clearly defined in the establishment of the joint venture. Examples might cover areas of industrial or support services, such as incinerators, with scope for income generation. Patient hotels, or other accommodation, to be used partly by the NHS and partly by the private sector, might be further examples.

Where joint venture projects receive consent, the private sector contribution will be treated as additional to NHS allocations.

Leasing

Certain leasing agreements will be permitted without the value of the asset counting against EFLs or allocations, provided the lease transfers the great majority of the risk to the private sector, and where leasing gives better value for money than purchase. Transferring risk could bring the NHS certainty over costs, without being tied to long-term use, and guaranteed ability to upgrade to more advanced technology and ability to dispose of old assets. New scanners or other medical equipment, for example, might be leased cost-effectively. This may also apply to leasing in computing and transport.

Services Provided by the Private Sector to the Public Sector

The changes reflected in the guidance notes offer further opportunities in an area where the NHS already makes considerable use of private finance. It may also widen the scope for market testing services in areas such as energy management and waste incineration projects, or other areas of patient services or support facilities, where the capital element of cost can be significant.

It is important to bear in mind that public sector bodies are constrained by the requirement to obtain value for money. Where

Health Bodies wish to promote projects involving private finance, it is vital that a full option appraisal is carried out. Such option appraisals should include the option of a public sector provision where this is a realistic alternative on a similar timescale to the private sector. It may be appropriate for the appraisal to address justification of higher levels of expenditure in terms of improved services (to patients etc) or other savings arising from differing timetables, and to include a discussion of why the project cannot be carried out within existing capital expenditure limits.

Where the private sector supplies capital, with the NHS contracting for the provision of a service, the private capital will be additional to NHS allocations.

The key that is stressed in all of the above is the transfer of risk. The public sector will, of course, continue to be unrivalled in its ability to spread risk. But the private sector often has a comparative advantage in managing risk, which the NHS should be keen to exploit. By working together, creating jobs in the private sector and developing NHS services, there will be gain to all sides.

PRIVATE FINANCE

Guidance for Departments

The Chancellor announced some important changes in the arrangements for privately raised finance in the Autumn Statement. They are set out in the attached extract from the printed Autumn Statement. They apply to Government departments and NDPBs and, in the case of leasing, nationalised industries. The purpose of this note is to advance the initiative by explaining the thinking behind the changes and offering preliminary guidance on the implications.

2. The Financial Secretary has been asked to carry forward and develop the policy with a view to encouraging the private sector to bring forward proposals and help identify any obstacles which frustrate its success. The guidance will accordingly be developed in the light of experience and of comments which are received.

Fundamentals

3. The purpose of the initiative is to enable the public and private sectors to work more closely together, while avoiding creative accounting. The fundamental points are that:

- the private sector must genuinely assume risk;

- there should be competition where the Government facilitates a project or seeks private sector partners, and also where the Government purchases services as a customer;

- the initiative applies not only to infrastructure projects but also to other capital investment which provides services to the public sector.

Mergers Commission if the project results in a monopoly situation. It may in some cases be appropriate to impose separate regulatory controls in place of, or in addition to, competition law although this would be likely to involve primary legislation.

Joint Ventures

15. The Government has said that it will actively encourage the private sector to join with it in joint ventures. These need not be limited to infrastructure projects. A project may be initiated by the Government, or the private sector may approach the Government with proposals.

16. The Government's new position on joint ventures does not affect the existing arrangements under which nationalised industries can participate in commercial joint ventures with the private sector.

17. Feasibility. Departments will need to decide, on the basis of an initial study, that the project is feasible; that it will lead to improvements in the delivery of their core objectives which are worth the Government paying a contribution, on which a ceiling should be set; and that after taking this into account private sector participation is viable on the basis that the project is remunerated by user charges.

18. The Government's contribution. This can take a number of forms, including concessionary loans, equity, transfer of existing assets, ancillary or associated works or some combination of these. (The procedures laid down in Government Accounting will need to be followed if existing assets are transferred.) There may also be a contribution in terms of initial planning or straight grant subsidy. Control of the joint venture must rest with the private sector participants. If there is a Government equity stake, it should not be a controlling one.

19. Expenditure by departments will need to come from existing public expenditure provision. Since the gearing up of departmental provision should make joint ventures particularly attractive, departments may wish to reconsider their allocation of PES resources with this in mind, and some may wish to earmark funds for possible joint ventures. It may be appropriate in some cases to use joint ventures for projects already in departments' programmes.

20. Each department will be accountable in the usual way for money used as contributions to joint ventures. It will therefore be necessary to compare the expected benefit of the expenditure with that which can be obtained from alternative uses of the money.

21. <u>Competition</u>. In all but the most exceptional cases there should be competition to choose the private sector partners. Preliminary discussions should be held with prospective bidders on issues such as risk structure. This will maximise the number of bidders and minimise the number of parameters in the competition itself. These may include such factors as the size of the Government's contribution and the benefits to the public sector or the public at large. There should be competition in the letting of contracts by joint ventures.

22. The EC Works and Supplies Directives will apply to contracts which are awarded jointly by the public sector and private sector partners or by the public sector partner alone. In the case of works contracts the Works Directive will apply if the project has majority funding by the public sector.

23. <u>Allocation of risk</u>. This should be set out in specific and clear terms in the legal documentation, so that the risk which each party undertakes properly reflects a clearly agreed structure of risk and reward. It is important to ensure that wide-ranging guarantees and indemnities are avoided. Departments should ensure that appropriate legal and financial advice is available, taking due account of the financial significance of particular projects.

24. Similar considerations on the position of Government as customer, the standing of promoters, intellectual property and competition law apply as with financially free-standing projects (see paragraphs 5 and 12-14 above).

Leasing

25. Unless purchase is clearly inappropriate, departments need before entering into leases to show that the advantages in terms of private sector management and the transfer of risk outweigh the higher cost of borrowing by the private sector. Departments will need to conduct appraisals of alternative leasing offers to ensure that best value for money is obtained. Arrangements which amount only to borrowing, without risk being located in the private sector, will not qualify. This includes sale and lease-back arrangements.

26. Effect on expenditure provision. In cases where the great majority of the risk stays with the private sector, the capital value of the leased asset will not be counted against expenditure provision. To date this assurance has only been available for leases satisfying a short-term need, and for property. Leases of property are not affected by the current change.

27. The change does not apply to leases where the great majority of the risk does not stay with the private sector. This includes finance leases, which the accounting standard defines as those leases where substantially all the risks and rewards of ownership are transferred to the lessee.

28. Guidance on the classification of leases with regard to risk is being prepared by the Treasury.

29. Competition. In accordance with normal practice, procurement should be undertaken by competition, unless there are convincing reasons for the contrary. Costs will need to be taken into account in deciding whether a full competitive tender is justified. If it is not, a way should be found to test alternative sources of supply. Departmental Accounting Officers are free to decide the circumstances in which a tender may be let without competition, subject to any statutory obligations which may apply. The Treasury should be consulted if a decision in a particular case appears to raise important issues of principle.

30. Departments need to ensure that the requirements of the EC rules on procurement are observed when they award contracts for the leasing of equipment or of buildings constructed to their specification. In the case of procurement covered by the Supplies Directive, the detailed rules apply if the estimated contract value on the basis of rules laid down in the directive exceeds the current threshold of £88,000.

31. All costs to the Exchequer should be taken into account, including tax benefits to the lessor through accelerated capital allowances if they are likely to be material to the outcome of the appraisal. Tax considerations can be ignored if the expected life of the asset concerned is less than 8 years.

32. Contract energy management. The change will enable the requirements for contract energy management to be simplified. Revised guidance is being prepared by the Treasury and DOE (Energy Efficiency Office).

33. Local authorities. The change does not affect local authorities, which are bound by statutory rules concerning those leases where the capital value of the asset concerned needs to be set against credit approvals. The rules contain a definition of finance leases which, except in the case of property, is intended to reflect the accounting standard.

Services provided by the private sector to the public sector

34. In addition to the changes above, announced in the Chancellor's statement, the Government intends to look for further opportunities for the private sector to provide services to the public sector. These will include cases where the greater part of the cost involves capital expenditure. Hitherto, private sector skills and expertise have been brought into many areas for which the public sector is responsible, but not usually in areas where there is a large capital component.

35. The main examples of private sector provision of this kind has so far been in the National Health Service, mainly in the provision of patient services in the form of care for the elderly, but there are also examples of clinical services involving major items of equipment being provided in this way. Departments are asked to consider what is possible in their areas of responsibility.

36. In order to obtain best value for money, public sector bodies should appraise the cost of obtaining services in this way against the cost of other alternatives (including public sector provision if this is a realistic alternative on a similar timescale). The appraisal will need to take account of how it is proposed to allocate risk. It is for the private sector to decide against its own criteria whether to make the investment involved.

37. If a department (or NDPB) enters into contractual arrangements with a private sector provider, these must be on a commercial basis and not involve dependence on the Government as a purchaser for the lifetime of a facility or the Government underwriting its use by other customers. The same provisions regarding competition apply as in paragraph 29.

9 December 1992

Private finance

2.111 Changes have been made to the arrangements for privately raised finance. The objective is to find new ways of mobilising the private sector to meet needs which have traditionally been met only by the public sector. The new arrangements are based on risk, which needs genuinely to be borne by the private sector.

2.112 In future, if the private sector is wholly responsible for a project which needs Government approval and can recoup all its costs by charges at the point of use, comparison with a theoretical public sector alternative will not be needed. Such a project will normally be put to competition. Under the current rules a comparison has generally been required if a project is one which the Government might have undertaken itself.

2.113 Secondly, the Government will actively encourage the private sector to take the lead in joint ventures. Participation by the private sector will be let by competition. The Government will specify its contribution in terms of money and risk. It is willing to consider debt and grant finance for such projects. If it takes an equity stake, it will not be a controlling one.

2.114 Thirdly, the public sector will have greater opportunity to use leases where they offer best value for money. The capital value of leased assets apart from property is at present usually offset against spending allocations unless the lease meets only a short-term need. In the future, the criterion will in all cases be based on risk, which is also the principle underlying the relevant accounting standard. Departments and nationalised industries will be able to enter into operating leases and count only the leasing payment against their provision, provided the great majority of the risk stays with the private sector.

2.115 In addition, the Government will be looking for further opportunities for the private sector to provide services for which the public sector is responsible, and in which the greater part of the cost involves capital.

2.116 Under the new arrangements, privately financed spending will be additional to public provision. The spending which is financed by Government will come out of departmental spending allocations. This is consistent with the principle that the control total should cover the spending which the public sector undertakes, or which it controls.

2.117 The Secretary of State for Transport will publish a Green Paper early in 1993 on the scope for charging for the use of inter-urban roads. If, in the light of consultation, the Government decides to proceed with charges, this could create significant new opportunities for private finance.