NHS Improvement

Paper Title: Subsidiary companies – policy approach

Agenda item: 4.1 (Private session)

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Paper type: For decision (NHSI only)

Summary/recommendation:
In December 2019, the NHS Executive Group considered proposals to update the transaction guidance for trusts forming or changing subsidiaries and the Provider Oversight Committee (POC) considered a specific case relating to Frimley Health NHS Foundation Trust (Frimley). Given the policy issues raised, the Boards are asked to agree the policy approach to the following material issues:

i. Strength of commercial rationale for the forming of subsidiaries/level of VAT savings;
ii. Level of staff engagement required in proposals that move staff away from standard Agenda for Change (AfC) terms and conditions; and
iii. The ability of foundation trusts[i] to transfer trust assets (specifically whole hospital sites) into subsidiary vehicles.

This will enable NHS Improvement (NHSI) to confirm the proposed changes to the updated guidance on subsidiaries

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Background

1. There has been an increasing number of trusts developing proposals for the use of subsidiary companies in recent years with 65 companies recognised in the annual accounts at 31 March 2019. These companies are a key FT freedom and can be used to deliver services innovatively and cover several different areas, including overseas trading arms, primary care vehicles, consulting services and the delivery of associated healthcare support services (e.g. estates and facilities management). There have been a number of successful subsidiaries set up in recent times, Northumbria Primary Care Ltd and Northumbria Facilities Management Ltd and Essentia Trading Ltd. However, the category including estates and facilities management, in particular, is becoming increasingly contentious because of the associated changes that these companies bring; often including proposals to move away from AfC pay-scales impacting low paid staff, the dominance of VAT and technical benefits driving the case for change, and the risks associated with transfers of assets into subsidiaries.

2. In November 2018, NHSI published an 'Addendum to the transactions guidance – for trusts forming or changing a subsidiary' which required trusts to notify NHSI of any proposals involving the use of subsidiary companies. This created a potential requirement for a review where the level of risk associated with the

proposals was deemed to potentially pose a significant risk to a trust's operations. It was recognised that the updated approach increased the regulatory burden on providers but there was a concern that trusts were forming subsidiaries solely to gain VAT benefits.

3. Over recent months there has also been escalating union opposition, including industrial action, over potential adverse impact on staff who are required to move to a subsidiary from the trust in question by TUPE transfer, and a related parliamentary debate about the transparency of plans.

4. NHSI committed to reviewing the approach after one year to consider whether it was appropriate and proportionate given the risks identified. A full discussion on the proposals was held at the Executive Group in December 2019, and we have brought the material issues discussed at that meeting to the Board for consideration and approval.

5. In addition, the recent case from Frimley has included all aspects of the contentious areas described in paragraph 1. The POC considered the case in December 2019, and resolved to refer the decision to NHSI's Board. Accordingly, he Frimley case is also for consideration at the January Board meeting. It should be highlighted, however, that Frimley's case is necessarily to be considered under the current transaction guidance which does not contain the detailed additions discussed in this paper.

Considerations

6. Our approach to updating the transaction guidance seeks to address the contentious areas we have identified over the last year by issuing more detailed guidance as part of our transaction risk rating approach which if not followed could provide evidence to red rate the transaction. The relative considerations and recommendations in each area are discussed in paragraphs 7 - 25 below.

Strength of commercial rationale and savings from VAT

7. There is often a significant financial benefit derived from the creation of subsidiary companies; our reviews to date have identified that, in most cases, a significant proportion of savings are predominantly VAT-savings (or VAT driven e.g. depreciation and capital charges savings) because of the differing VAT treatment available to subsidiaries. Trusts must be mindful of Department of Health and Social Care (DHSC) guidance that tax avoidance arrangements should not be entered into. The current guidance therefore states that proposals must show "a clear commercial strategy for the proposals which is independent of VAT treatment".

8. For a number of subsidiaries, trusts have been able to demonstrate genuine commercial reasons for creating an arms-length service. One of the driving reasons is the ability to ringfence and focus dedicated management time, a key reason cited for their development. However, in recent cases the savings from VAT often seem to be the predominant drivers of the financial benefits.

9. Our work to date has sought to test the robustness of the non-VAT benefits presented via an opinion from an independent tax adviser and with a rule of thumb that we expect the majority of benefits to come from non-VAT savings.

10. At this time, no definitive guidelines have been issued by HMRC in relation to the use of these schemes by NHS-owned companies (except as issued in the DHSC guidance letter), however, there is a risk that should VAT savings continue to increase, HMT may reconsider the funding of VAT through tariff, thus eliminating the benefit.

11. In light of concerns raised around the strength of the commercial rationale for subsidiaries, we are recommending the updated guidance for subsidiaries sets an expectation that:

    a. the trust business case will set out:
        i. a clear case for change and commercial rationale for the set-up of the subsidiary;
        ii. an options appraisal of alternative approaches
        iii. consideration of how the commercial rationale for the subsidiary is aligned with system plans for back office consolidation and transformation;
        iv. For estates proposals, a demonstration of how a subsidiary supports the provision of services and improvement of the estate; and
        v. Confirmation of the treatment and protection of assets.
    b. the majority of operational savings resulting from the creation of a subsidiary should be from non-VAT savings, but the guidance will note a flexibility to consider exceptional circumstances e.g. material non-financial benefits.
    c. NHSI will retain the option to request an external VAT opinion.

12. For all significant transaction reviews involving the set-up of subsidiaries we will test the evidence to support areas a-c.

Changes to AfC/staff engagement

13. If they so choose, foundation trusts may lawfully move away from AfC terms and conditions, and several trusts have done so in the subsidiary companies they have set up. A number of proposals rely on moving staff into a subsidiary (via TUPE) and offering amended terms and conditions (including pensions and/or more flexible pay terms including bonuses) for new staff. These changes are predominantly to allow them to offer different rates of pay to those allowed under AfC for equivalent banded jobs, and to offer more dynamic/attractive terms and conditions, particularly where there is a shortage of the skills in the market.

14. The transfer into a subsidiary and a change in terms for new staff, may also impact on:
    a. an employee’s continuity of service within the NHS, should they leave the subsidiary in future; this in turn may affect the employee’s paid leave entitlements; and

b. the ability of new employees to access the NHS Pensions Scheme, as there is no guarantee that the pension scheme will be accessed by the subsidiary (as the Scheme is subject to a formal application process).

15. Whilst there can be a legitimate rationale to offer different terms and conditions in certain labour markets, and one which can bring recruitment and retention benefits, concerns have ensued that subsidiary vehicles may adversely impact the lower-banded workforce and a perception at least that a two-tier workforce is created. In addition, unions are concerned that staff engagement has not been sufficient in relation to the proposals with limited explanation of the case for change.

16. This has led to industrial action (including in Birmingham and Solihull, Bradford and Frimley) and union involvement at a national level. The unions feel that the consideration of staff engagement is not given the same weight as financial, operational or quality factors in the review and that this is not consistent with the NHS People Plan around listening to staff.

17. NHSI has no legal power to prevent foundation trusts establishing a subsidiary (save potentially where the trust is under formal licence breach and enforcement powers are deployed) and in consequence also cannot mandate attendant requirements. However, to address the various concerns NHSEI is developing a best practice checklist with the People Directorate, in consultation with Trade Unions. The aim of the checklist will be to ensure that trusts engage as fully as possible with staff and that the rationale is not predicated on paying staff less.

18. In addition, we are proposing to amend the guidance to include an expectation that trust boards have:

a. undertaken comprehensive staff engagement on the commercial rationale and consequences for staff;
b. appropriately considered the labour market for each category staff before determining the approach to terms and conditions, for example a move away from AfC may be acceptable to staff in competitive employment markets but less so where the trust acts as the major employer;
c. appropriate consideration of pension and continuity of service issues for staff;
d. had regard to the good practice staff engagement guidance and to make additional self-certifications in this area including reference to good practice, terms and conditions, pensions, equality impact assessment; and
e. provided a reasonable level of transparency about plans, for example public articulation of options considered.

19. For all significant transaction reviews involving subsidiaries we will test the evidence to support areas a-e. We will also adapt our review approach to ensure we use regional workforce subject matter experts when considering risks associated with terms and conditions. We will also test mitigation planning around potential strike action.

20. Finally, whilst we are proposing to relax the reporting requirements for subsidiaries to be aligned to our main transaction guidance (reporting only those which are 10% of income/assets), we will impose a further reporting threshold to NHSEI for subsidiaries involving the transfer of 5% or more of staff. NHSEI will then undertake a review of the risk factors (including around T&Cs and estates risks) to determine whether a significant transaction review is required.

Asset transfers/estates risks

21. The estates input from NHSI in reviewing schemes to date has identified a risk that some trusts have not undertaken sufficient market testing for estates proposals and the quality of business planning has been mixed.

22. Further risks have been identified where trusts have proposed that assets are transferred into the subsidiary company. While a number of these transfers have been proposed through long-term leasing arrangements, a recent proposal includes the transfer of whole-site hospitals into a subsidiary.

23. A number of risks to this arrangement have been identified by the NHSI Estates Team including the:

a) risk of onward sale if adequate protections are not included;
b) potential for tax liabilities to arise in future should the estate change hands (both stamp duty and capital gains taxes);
c) potential for finance to be raised against the assets opening up a risk of transfer to a third party;
d) ability for trusts to access PDC funding (and other funding) from DHSC where the trust does not own the assets directly; and
e) ability of the subsidiary to dispose of lower value assets which could place a risk to trust future plans and services.

24. In response we are proposing to amend the guidance to include an expectation that where assets are transferring, trust boards have considered:

- the level of control required in the subsidiary to ensure sufficient oversight of the asset including parent company approvals required for capital investment and disposals;
- the exit strategy should a service contract with a subsidiary be terminated and the associated financial and operational impact quantified;
- the availability of funding sources in the absence of DHSC funding, to ensure that assets were maintained to the required healthcare standards; and
- the protection of assets.

25. For all significant transaction reviews involving subsidiaries we will test the evidence to support areas in paragraphs 23 and 24. We will also ensure early engagement with NHSEI's Estates Team and updated self-certification statements on market testing.

Issues

Strategic Alignment

26. This proposal is linked to both the overall financial position of the NHS, in terms of its ability to develop plans that deliver its financial efficiency requirements, as well as consideration as to how organisations develop plans that allow them to deliver services differently and more effectively in the future, and the extent to which subsidiary companies may form a part of this improved delivery mechanism.: for example, the use of subsidiaries to deliver pharmacy and pathology services.

27. The proposal also considers the terms and conditions of NHS staff and is therefore related to the proposals outlined in the NHS People Plan.

Risk analysis

28. NHSI does not have the legal power to prevent a trust from setting up a subsidiary. However, through the regulatory approach set out in the transaction guidance, NHSI will issue a transaction risk rating for cases posing significant risk which acts as an indicator to trust boards as to NHSI's view on the associated risks and whether the trust should proceed. A 'red' rating would indicate that we would expect a trust board to abandon the set-up of a subsidiary in the manner proposed. Whilst a 'red' rating does not prevent an FT from acting, should the FT proceed with the set-up of the subsidiary, we may be able to intervene on the basis that there was a governance failure constituting a (potential) licence breach and in that way halt the process.

29. Increasing the regulatory burden in this area may stifle one of the remaining freedoms for FTs[1] and prevent this innovation and change.

Financial commentary

30. It is the case that a number of trusts have identified subsidiary schemes as key efficiency drivers built into current financial system plans and thus, without the cases being approved, present an additional financial challenge to trust and system plans. In recent cases we have seen the level of operational annual savings assumed from estate and facility subsidiaries often in the region of £10m and this can increase significantly if major capex is planned.

Summary and key points

31. The additional guidance proposals in this paper reflect the learnings and stakeholder feedback over the last year. The updated approach strikes a careful balance which aims to preserve the risk-based regulatory approach and allow FTs flexibility to pursue integrated care models, respond to national productivity programmes and continue to innovate and support efficiency and sustainability. At the same time the changes recognise the importance of transparency and staff engagement during the implementation of change in light of the commitments in the NHS People Plan.

[1]'it remains the case that NHS trusts may only establish subsidiaries for income generation purposes. For that reason, therefore the subsidiary proposals we have seen have been put forward by NHSFTs.

32. It is necessary for our policy approach to be finalised on the points outlined above in order to finalise and provide clearer guidance to trusts of our expectations of when setting up subsidiaries.

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[i] NHS trusts can only set up subsidiaries which are for income-generation purposes; accordingly this paper focuses on NHSFTs.