NHS Improvement

Consultation on our proposed extension to the review of subsidiaries

October 2018

We support providers to give patients safe, high quality, compassionate care within local health systems that are financially sustainable.

Contents

1. Summary

This consultation outlines proposals for a new framework that changes the way subsidiaries are reported to and approved by NHS Improvement. These do not affect the legal ability of providers to develop plans but do clarify the required approval process before plans can be implemented. We also list the guidance being developed to support providers with their plans. We want the new framework to strike the right balance between assuring us and respecting NHS freedoms and the ability of the NHS to innovate.

The consultation will be open for four weeks, closing at 5pm on 16 November 2018. Following this we will publish a summary of your comments and responses to our questions, as well as our response to the points you raise. Your responses will also be considered before we publish our updated guidance and implement the new process, which we expect to do in December 2018.

The creation of subsidiary companies by NHS foundation trusts is a long-standing ability created by the National Health Service Act 2006. NHS foundation trusts can establish subsidiaries to deliver a variety of services including NHS healthcare, pharmacy, catering and estates management, as well as for income generation. NHS trusts may only establish subsidiaries for income generation. As the NHS faces a period of significant change, trusts are increasingly looking at innovative ways of managing their financial and operational delivery and many are considering the use of subsidiary companies (or similar vehicles) to do this.[1]

As part of several national programmes (eg pathology, pharmacy and imaging) NHS Improvement is reviewing the way trusts are delivering services to identify alternative, more effective mechanisms. These programmes may identify the creation of a subsidiary company as the most effective mechanism, although their focus is identifying and developing the most appropriate solution for the trust and its local environment. We recognise that the NHS needs to be innovative if it is to ensure the sustainability of service delivery and subsidiaries can deliver real value

[1] The terms ‘subsidiaries’ or ‘subsidiary companies’ in this document apply to all types of organisation owned or partly owned by a provider. ‘Subsidiaries’ includes companies limited by guarantee or companies limited by shares, community interest companies and limited liability partnerships.

to patients by generating profit to be reinvested into services. But it must always manage risks appropriately and ensure the long-term provision of essential services is not undermined.

2. Existing arrangements

NHS Improvement's transactions guidance is the prevailing framework for the review of any transactions by providers, including investments in subsidiaries (companies limited by guarantee, companies limited by shares, community interest companies and limited liability partnerships). This guidance outlines when plans for the creation of a subsidiary need to be reported to NHS Improvement before they can proceed.

2.1. Current transaction reporting thresholds

Our reporting and review requirements

Under the current transactions guidance, we assess any transaction that meets the reporting and review thresholds. A trust should report a potential transaction that meets any of the criteria listed in Table 1 to NHS Improvement.

Table 1: NHS Improvement reporting requirements

		Reporting requirements	
Ratio	**Description**	**Non-healthcare/ international**	**UK healthcare**
Assets	The gross assets* subject to the transaction* divided by the gross assets of the trust	>5%	>10%
Income	The income attributable to the assets or contract associated with the transaction* divided by the income of the trust	>5%	>10%

Consideration to total trust capital	The gross capital** or consideration associated with the transaction* divided by the total capital of the trust following completion, or the effects on the total capital*** of the trust resulting from a transaction*	>5%	>10%

* Gross assets are the total of fixed assets and current assets.
** Gross capital equals the market value of the target's shares and debt securities, plus the excess of current liabilities over current assets.
*** Total capital of the foundation trust equals taxpayers' equity.

Approach to transaction review

The degree to which we scrutinise any proposed transaction depends on our perceived level of its inherent risk. This level determines whether a transaction is classified as 'small', 'material' or 'significant' which in turn reflects the level of review necessary and, as outlined in the transactions guidance, is itself determined by several factors including the nature of the transaction and the performance of the trust at that time. As a minimum, any transaction that triggers one of the thresholds in Table 1 will be considered at least 'material' and will require the completion of a trust board certification.

Material transactions – requirements

Where we classify a transaction as material, we, as part of our overall assessment of financial and governance risk, request evidence in the form of certification that the board has satisfied itself in relation to the key areas of risk set out in Appendix 8 of the transactions guidance. For certain transactions we may require trusts to provide additional evidence to support their certification. The certification should be submitted to and agreed with us before the trust enters into any legally binding arrangements in relation to the transaction. In addition, within six months of completing the transaction, the trust board should make a revised corporate governance statement (see Appendix 8 of the transactions guidance) and send this to its NHS Improvement regional team, except for the statement concerning quality governance for which an appropriate timescale for compliance should be determined by the trust board and agreed with us.

Significant transactions – requirements

Where we classify a transaction as significant, we require a greater degree of assurance regarding the risk a trust will breach their licence conditions, or their equivalent for NHS trusts. As well as the evidence requested for a material transaction, this comprises a detailed review of how the proposals affect the risk profile of the trust. This is likely to include the review of a long-term financial model outlining the financial plan for the proposals.

In undertaking our review, we look in detail at up to four domains, depending on the nature and risks of the proposed transaction:

- strategy
- transaction execution
- quality
- finance.

On completion of the review, a transaction risk rating is granted. ‘Green’ or ‘amber’ allows the trust to proceed with its proposals, although this may be subject to additional oversight and monitoring post transaction if risks have not been adequately mitigated but are not so great as to stop the transaction.

2.2. Legal powers – disparity between NHS foundation trusts and NHS trusts

NHS foundation trusts have power under Section 46 of the NHS Act 2006 to form subsidiary companies for the purposes of, or in connection with, the exercise of their functions – that is, for purposes of core NHS healthcare provision. They may also form subsidiary companies for income-generation purposes. Currently 65 subsidiary companies are of sufficient size and/or controlling influence to register in foundation trust accounts.

NHS trusts have a more limited power under paragraph 20(2) of Schedule 4 of the NHS Act 2006 to form or participate in ownership of a subsidiary company for income-generation purposes only – that is, making additional income available by performing non-NHS services: “An NHS trust planning to set up a subsidiary for the purposes of income generation can only do so:

(a) to the extent that it does not, to any significant extent, interfere with the performance of its functions or its obligations under NHS contracts; and

(b) in circumstances specified in directions under section 8 of the 2006 Act, with the consent of the Secretary of State."

Proposals for income-generating NHS trust subsidiaries must be checked and approved by the Secretary of State pursuant to directions to NHS trusts dated September 2002. We include a link to the relevant directions in the Section 2.4 'Further information for NHS foundation trusts and NHS trusts'.

NHS Improvement, NHS England and the Department of Health and Social Care (DHSC) all consider that the general legal power of NHS trusts to do anything that appears necessary or expedient in connection with their functions does **not** allow them to form or participate in companies for the purposes of core NHS healthcare provision.

We clarified the legal position in *Guidance on options for structuring foundation groups*: "NHS foundation trusts can take part in corporate joint ventures with other NHS foundation trusts. But NHS trusts do not currently have the power to set up or participate in corporate bodies except for income generation (ie making additional income available). The corporate joint venture model is therefore currently limited to foundation groups that only involve NHS foundation trusts."

However, differing legal opinions exist about whether NHS trusts can set up subsidiaries to deliver core functions. The settled position remains as set out above and trusts are discouraged from seeking legal advice, at the public expense, on this issue.

The legal position for NHS trusts is not something that NHS Improvement can change through this consultation. Subsequent to this consultation, our update to the transactions guidance will reconfirm the legal position for NHS foundation trusts versus NHS trusts and will outline the DHSC process for assuring that an NHS trust subsidiary proposal is income generating.

2.3. VAT issues

The Health and Social Care Act 2012 established a level playing field for all qualified providers to provide NHS-funded services, to encourage greater diversity of supply and improve patient choice. As such, all providers, be they NHS or private sector, must operate within the existing VAT legislation that applies to their particular entity.

DHSC wrote to the finance directors of all NHS providers in September 2017 to remind them of their responsibilities around tax and advising that tax avoidance arrangements should not be entered into under any circumstances. We would expect all NHS providers to follow this guidance when considering any new arrangements or different ways of working.

The letter also stated that trusts should not be spending money on private sector consultancy support in the development of such proposals as this represents active leakage from the healthcare system. This message is consistent with advice provided in Section 5.6 of HM Treasury's *Managing public monies* guidance (July 2013).

2.4. Further information for NHS foundation trusts and NHS trusts

Foundation trust subsidiaries which provide healthcare services may be required to hold an NHS-controlled provider licence. For more information, see *Licensing application guidance for NHS-controlled providers*.

We have published guidance on various types of organisational forms in the context of new care models:

- *Oversight of new care models: your questions answered*
- *Illustrative scenario modelling of providers organisational forms*.

NHS trusts considering income-generating subsidiaries should consider the following guidance:

- *National Health Service: Income generation – best practice* (Department of Health, February 2006)
- *The use of companies in income generation by the NHS* (Department of Health, 1 April 2005)
- Directions relating to the exercise of powers under section 7(2) and (7A) of the Health and Medicines Act 1988 (Department of Health, 9 September

2002). The directions can be found at Appendix 5 of *The NHS as an innovative organization. A framework and guidance on the management of intellectual property in the NHS*.

We have also published guidance on potential contractual arrangements for trusts considering developing subsidiary plans.

- pathology networks toolkit
- corporate services productivity toolkit.

We plan to publish further guidance for trusts on completion of the consultation process and introduction of the new approach.

3. Justification for a change in reporting thresholds

We recognise that there are circumstances where subsidiary companies are appropriate and can help drive innovation. However, we need to make sure that only those business cases that genuinely create value for the sector proceed. To do this we, alongside DHSC, have considered the extent to which proposals need to be further scrutinised before implementation. This enhanced scrutiny reflects the operational and financial challenges some providers have faced on implementation of new proposals, as well as the need to ensure that proposals are developed to deliver a long-term improvement in quality and ensure sustainability, and do not focus solely on securing the VAT savings that can often be made with the creation of a subsidiary.

We recognise that these proposals will increase the regulatory burden on some providers and we will commit to reviewing them after one year to consider whether they are still appropriate and proportionate. We will in due course align the subsidiary review process with the transactions guidance, but first need further information and a better understanding of the risks inherent within these proposals. With this we can set a definitive ‘bar’ for a subsidiary to be reportable, and identify the level of review required according to the inherent risks.

As stated above, NHS Improvement cannot change the legal parameters for the creation of subsidiaries. However, we can more effectively test the extent to which proposals have been developed with full consideration of a number of risks and/or challenges. These include but are not limited to:

- Have alternative contractual arrangements been considered alongside subsidiaries to ensure the latter is the most appropriate structure, including consideration of the long-term environment and any potential changes (eg cross-provider co-operation through sustainability and transformation partnerships)?
- Have staff been fully and actively engaged during the process (where relevant) to ensure that their views are factored into the proposal?

- To enable transformation, are the risks to the trust from an arm's-length subsidiary fully understood, has appropriate due diligence been undertaken on associate partners, and are exit strategies and risks understood?
- Are the economic risks to the model fully understood, particularly in relation to the availability of public dividend capital (PDC) and funding for workforce pressures?
- Are structures appropriate?

4. Proposed extension of approach

In this section we describe our proposed extension of the current framework. This affects the reporting of subsidiaries as transactions and the accompanying review process, and both income-generating and non income-generating proposals. **Business cases that make a material change to an existing subsidiary will also be subject to our revised process.** As with the creation of subsidiaries, trusts should report proposed material changes to us. Subject to this consultation, we plan to update our transactions guidance.

The changes are:

1. The establishment of a subsidiary (regardless of size, legal structure or purpose) becomes a transaction that is ‘reportable’ to NHS Improvement. We will require the submission of a trust-approved business case detailing the nature of the proposals and the plan’s inherent risks.

2. Each business case will first be reviewed by a group within NHS Improvement (the panel) to determine the whether a transaction is material or significant and the level of further review required (if any) based on the risks inherent to the proposal. The panel will include subject matter experts across a number of areas (eg pharmacy, pathology and estates) as well as members of NHS Improvement’s transactions review team. The panel will consider the specific aims of the business case alongside the overarching legal, governance, financial and operational impacts of the proposals on the trust and its patients.

3. For NHS trust income-generation proposals, the business case must demonstrate to the Secretary of State that the subsidiary is income generating. Following this assurance, the panel will decide whether the transaction is material or significant.

4. If the panel determines a full review is not required, the business case will be classified as ‘material’ (as currently defined in the transactions guidance). In this

scenario, we will ask the trust board to confirm the following statements, by way of board certification, before establishing the subsidiary:

- the business case can clearly articulate how the subsidiary will create genuine value for the trust: for example, simply moving assets into a subsidiary may not meet this test
- the business case stands in the absence of any VAT savings
- there are clear business reasons why a subsidiary structure is preferable to other organisational forms and there is sufficient flexibility for future operations that do not put the organisation at risk
- the trust can clearly articulate how the subsidiary will be established, managed and monitored, including a considered exit strategy
- appropriate licences will be obtained for the purposes of the subsidiary, including the requirement for an NHS provider licence, where relevant
- the revised board certification will require trust boards to consider and appropriately address further specific risks: for example, the ability to access PDC funding in the future. This will build on the current board certification in our transactions guidance.

As more business cases are reviewed, we anticipate we will be able to articulate where the 'bar' will be set between requiring and not requiring a full review. This bar will be incorporated into the transactions guidance in a future update. We propose to review these requirements one year after implementation.

If the panel determines that a full review is required, the proposal will be classified as a 'significant' transaction (as currently defined in the transactions guidance). This means that a separate review process will be necessary, in addition to the board certification above. As with current 'significant' transactions in the transactions guidance, review will include a series of planned meetings with the trust to understand the proposals in more detail and how the board has been assured of the risks involved through the framework set out in the transactions guidance. If following a full review, we consider the business case to be too risky to progress, the review team will recommend to an NHS Improvement executive committee that the transaction is risk rated 'red', meaning that we consider the issues arising from the review to be serious enough to delay the transaction. The trust will need to address the risks posed by these issues by restructuring the proposal to our satisfaction before it can be enacted. If the trust considers this is impossible, we will use our regulatory powers to stop the transaction if required.

The proposed changes will also apply to any future ‘material’ changes to an existing subsidiary to ensure that all risks are fully considered – that is, such proposals will be considered as if the trust were making a new investment.

We recognise that the term ‘material’ is judgemental and we want to define it following consultation feedback and initial reviews. Please give us your views on how ‘material’ should be defined as part of your consultation response (see Section 6).

5. Proposal for implementing the change

In September 2018, we asked all providers to ‘pause’ their current plans for wholly-owned subsidiaries where approval is sought, although preparatory and other work to develop new models could continue. We are expecting several trusts to enter the new process, subject to the completion of this consultation and the implementation of the new requirements in December 2018.

We will publish guidance to support providers in considering their proposals in light of our changes, including:

- a supplement to the transactions guidance outlining the specific requirements for subsidiary transactions
- a revised board certification that references subsidiary-specific risks
- recent findings and key information on the creation of subsidiaries and consolidation of all existing guidance for ease of reference.

We will continue to engage with trusts about their subsidiary proposals plans and how they can incorporate the revised process in their planning.

6. Responding to this consultation

You need to respond to this consultation by **5pm on 16 November 2018** via our survey. Please email nhsi.subsidiaries@nhs.net if you have any difficulty accessing the survey.

Please let us know (by emailing nhsi.subsidiaries@nhs.net) if all or part of your response or identity is confidential so that we can exclude this from our published summary of responses. We will do our best to meet all requests for confidentiality, but because NHS Improvement is a public body subject to freedom of information legislation we cannot guarantee that we will not be obliged to release your response (including potentially your identity) or part of it even if you say it is confidential.

We will publish a summary of the responses on our website and our response to the points raised. We will consider your feedback in advance of publishing the updated guidance and implementing the new process in December 2018.

Consultation questions

1. Do you agree that all subsidiary proposals should be reported to NHS Improvement regardless of value? Yes/No

2. What criteria or threshold do you think should make the creation of a subsidiary a 'reportable' transaction?

3. Do you agree that a 'material change' to a subsidiary should also be reported as a transaction? Yes/No
   If you do not agree, why not?

4. How do you think a 'material change' should be defined?

5. Do you agree that a panel review is an appropriate way to determine whether a proposal for a subsidiary should be classified as 'material' or 'significant' and reviewed accordingly? Yes/No
   If you agree that a panel review is appropriate, what risk factors should the

panel consider to determine whether the proposal is ‘material’ or ‘significant’? **If you do not agree**, what do you consider is the appropriate way to determine this classification, eg set criteria?

6. Do you agree with the proposed make-up of the panel? Yes/No
   If you do not agree, who should be included on the panel?

7. What risk factors should the board certification cover?

Contact us:

NHS Improvement
Wellington House
133-155 Waterloo Road
London
SE1 8UG

0300 123 2257
enquiries@improvement.nhs.uk
improvement.nhs.uk

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