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## ANALYSIS



## Borrowing to save: can NHS bodies ease financial pressures by terminating PFI contracts?

Mark Hellowell describes the first buyout of a PFI contract by an NHS foundation trust and explores whether other NHS bodies might be able to do the same

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Public spending on the NHS is due to fall as a proportion of gross domestic product, from a peak of 8% in 2009-10 to just over 6% in 2020-21.<sup>1</sup> The proportion of NHS and foundation trusts in deficit rose from 10% in 2012-13 to 26% in 2013-14, highlighting the scale of the financial challenges facing NHS organisations.<sup>2</sup> The payments that trusts are obliged to make under private finance initiative (PFI) deals are a source of budgetary pressure.<sup>2</sup> By March 2013 a total of 121 PFI deals had been procured by NHS bodies in England, with an aggregate capital value of £11.8bn (\$18.3bn; €16.6bn) and a projected cash cost to the NHS of £81.5bn, £70.1bn of which remained outstanding at that date.<sup>3</sup> Two thirds of trusts with a deficit greater than £25m have a PFI deal.<sup>2</sup>

Numerous calls have been made for PFI contracts to be renegotiated.<sup>4</sup> Although there is limited scope to reduce the payments to PFI consortiums, NHS bodies normally have the right to terminate them for a price. Interest in the termination approach has grown among NHS bodies after the decision by Northumbria Healthcare NHS Foundation Trust to borrow money from a local county council to buy out the PFI contract for Hexham General Hospital. The termination was completed in October 2014, at which point the PFI was costing the trust approximately £8m a year and had a further 18.5 years left to run.<sup>3</sup>

Before the trust could proceed it had to demonstrate that the long term cost to the public sector of terminating the PFI contract would be lower than that of continuing with it. The trust appointed the consultancy Deloitte to make this comparison. Under the Freedom of Information Act, I accessed Deloitte's assessment and the correspondence (between the trust, the Treasury, and the Department of Health) relating to it (box). Here, I draw on these documents to evaluate the long term costs of terminating the Hexham PFI deal. I then assess the extent to which the termination approach can provide other NHS bodies with an efficient means of lowering their costs.

### Costs and benefits of termination

The fee paid by the trust to the consortium to terminate the contract had to cover both the costs of ending the consortium's financial and contractual commitments and the market value of its equity stake in the project. It was also subject to corporation tax, and the consortium was entitled to compensation for this from the trust.

Deloitte's analysis showed that in April 2013 the trust estimated that the fee would be £107.2m (table 1⇓). In the event, the trust had to pay £114.2m to bring the contract to an end.<sup>5</sup>

To help the trust weigh up their options, Deloitte estimated the cash costs of two outcomes: terminating or continuing the PFI contract (table 2⇓). The comparison covered a 25 year period—from October 2014 to September 2038—in which the trust was due to repay the loan from the local county council. Prior to its termination, the PFI contract had been due to end in April 2033.

Repayment of the £114.2m loan at the fixed interest rate of 3.98% accounted for most of the estimated cost of termination (£180.46m). In addition, the trust would pay for maintenance and ancillary services that were provided by the consortium under the PFI contract but would become the responsibility of the trust after termination. These costs were estimated by the trust to be £1.14m a year, which over 25 years would total £36.58m, assuming that they were to rise at the Bank of England's consumer price index inflation target of 2% a year. Thus the total cost of terminating the contract was estimated to be £217.04m.

The majority of the cost of continuing with the contract comprised payments to the consortium. These payments were, like most PFI contracts, linked to the retail price index, which tends to be higher than other inflation measures, including the consumer price index.<sup>2</sup> Assuming retail price index inflation of 3.68% a year over the period to April 2033, the total cash cost of the payments to the consortium would be £222.5m. Under this option, the trust would incur operating expenses after the contract ended until the end of the comparison period. If these

**Key documents used in this analysis**

Freedom of Information Act: Department of Health internal review case reference IR719074, Northumbria Foundation Trust PFI analysis, 23 October 2014.

Deloitte's analysis: Northumbria NHS Foundation Trust: Hexham PFI termination value for money assessment, 19 April 2013.

Letter from the head of procurement, investment and commercial division to the permanent secretary. Department of Health. 28 August 2013.

HM Treasury draft report on Northumbria PFI termination: for DH comments, 2013.

expenses were to rise at the forecast consumer price index, the associated costs would be £8.8m. Thus the total cost of continuing the contract was estimated to be £231.35m, and termination would reduce costs by approximately £14.3m.

However, this estimate is sensitive to variation between expected and actual inflation. If operating expenses were to rise at a higher rate than forecast (and inflation measured by the retail price index was unchanged), the estimated saving would be reduced. The saving would also be reduced if inflation measured by the retail price index was lower than forecast (and inflation measured by consumer price index was unchanged).

In addition to this estimated cash saving, the termination also resulted in changes to the trust's balance sheet that reduce its annual expenditure. Trusts have to pay a "dividend" to the Department of Health based on 3.5% of the value of their net assets—that is, the value of their assets, such as property, minus the value of their liabilities, or debts. As of April 2013, it was expected that the termination fee, less the outstanding debt on the PFI contract, would generate an operating expense for the trust of £52.8m, leading to a deficit of £51.9m. This reduces the value of the trust's net assets and thus the dividends payable to the department.

However, from the perspective of the public sector as a whole, there is no saving—only a change in the allocation of resources between the trust and the department, as detailed in the letter from the department of health to the permanent secretary. For that reason, the trust conducted the balance sheet impact separately from the value for money comparison (which focuses on relative costs from the perspective of the public sector as a whole) on its finances in April 2013. Although the details of the analysis are not available, Deloitte drew on this to calculate an associated saving to the trust of £10.2m from April 2014 to September 2033 in net present value terms. As noted, this reduction in the dividend represents a saving for the trust but an equivalent cost for the Department of Health.

**Lessons for the NHS**

It is striking that, having paid £67m over 10 years for the use of a hospital with a capital value of £54m,<sup>3</sup> the trust had to make a further payment of £114.2m to bring the contract to an end. Despite this, the trust still predicted it could save approximately £14.3 million over 25 years by terminating the contract, mostly due to lower capital and operating expenses. Other NHS bodies are likely to want to replicate such an approach to easing their financial pressures. How feasible is this?

Clearly, Whitehall cannot easily prevent future terminations on financial grounds—at least in the case of foundation trusts, which are semi-independent from the Department of Health. The letter from the department to the permanent secretary indicates that civil servants thought the Hexham example could be repeated by other NHS bodies, with "unbudgeted financial consequences for the departmental and national accounts." Treasury officials, though, noted in their draft report that "under the current legislative framework, we cannot see how the trust

can be prevented from incurring this expenditure on affordability grounds."

**Obstacles to termination**

Yet there are a number of potential obstacles for trusts that would like to follow this example. Firstly, only a small number of foundation trusts have the finances to fund the large amounts required to terminate a PFI deal.<sup>2</sup> Monitor, the financial regulator of the NHS, reviewed the effect of the Hexham termination on the ratio between the trust's available income and annual payments due on its debts and agreed that it would not affect financial risk.<sup>3</sup>

Some other foundation trusts, such as Northumberland, Tyne and Wear, and Oxleas, which have robust finances and PFI contracts at a mature stage of operation,<sup>2</sup> might receive approval from their financial regulator, Monitor, on similar grounds. Trusts with the largest deficits, however, for whom the savings associated with termination are most important, are the least able to pursue this option.

Secondly, the Hexham termination was possible only because of a local county council's willingness and ability to provide a loan. In so doing it reduced its ability to borrow for its own capital requirements and exposed itself to considerable financial risk. Given the tight financial constraints faced by local authorities in the coming years, few trusts are likely to have this option.

Thirdly, the termination fee may be so high that any savings would be negligible or even non-existent. Most PFI deals in the NHS have long term financing agreements because consortiums need to be insulated against changes in interest rates. For many contracts the cost of finance was fixed when interest rates were considerably higher than they are today.

The fees associated with debt repayment or breakage (or both) may lead to a termination sum that exceeds, by a considerable margin, the outstanding PFI liability.<sup>6</sup> For example, the consortium that holds the Barts Health NHS Trust PFI contract, which has a capital value of £1.1bn, has the third highest debt of any PFI consortium in the UK, at £1.3bn.<sup>2</sup> The consortium that operates the Peterborough and Stamford Foundation Trust's PFI contract has the third largest interest rate swap liability in the public sector, at £79m.<sup>2</sup> For these two trusts—which also recorded the largest deficits among all NHS and foundation trusts in 2013-14—securing financing on such a scale may not be financially feasible.<sup>2</sup>

**Future options**

If contract termination is not the answer to ending the financial pressures created by PFI schemes, then what is? Given the scale of the situation, it is incumbent on policy makers to carefully consider the alternatives.

The simplest and most effective response is to adjust the payments made to trusts by commissioners to ensure that they are adequately compensated for their costs, including capital

costs. All else being equal, these costs are likely to be higher for trusts with operational PFI contracts than for other trusts. The financial pressures created by PFI contracts are disproportionate to their aggregate cost (£1.95bn per annum, less than 2% of the NHS budget<sup>3</sup>), and this is because the burden is concentrated among a minority of trusts.

Since 1994 private finance has been the only option for new hospitals, and this continues to be the case under the government's "Private Finance 2" scheme.<sup>7</sup> Although mistakes were made by individual trusts in the commissioning of large scale PFI projects, most of them had no choice but to use PFI for what were widely recognised as non-discretionary investments. In this context, failing to reimburse trusts for their capital costs seems inequitable, and in an era of unprecedented spending controls this has the potential to compromise patient care.<sup>4</sup>

Contributors and sources: MH is a senior lecturer in health systems analysis at the University of Edinburgh. He is an adviser to the World Bank on issues of public-private sector engagement in healthcare, and acts as special adviser to the Treasury Select Committee on the private finance initiative and related phenomena. The data on which the analysis in this article is based were extracted from documents prepared by Deloitte on behalf of Northumbria Healthcare NHS Foundation Trust,

along with correspondence between senior officials in the foundation trust, the Treasury, and the Department of Health.

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**Key messages**

The first large scale termination of a PFI contract was achieved by Northumbria Healthcare NHS Foundation Trust for Hexham General Hospital

Having already paid £67m over 10 years for the use of a hospital with a capital value of £54m, further payments of £114.2m were made to bring the PFI contract to an end. The trust expects the termination to secure appreciable long term savings

As terminations are likely to require large additional expenditures in the short term, trusts under the most serious financial pressures are the least likely to undertake this approach

Dealing with the problem of PFI payments is likely to need a coordinated response from central government to ensure that trusts are reimbursed for their related costs

**Tables****Table 1| The trust's estimate of the termination fee<sup>6</sup>**

Component	Estimate (£m)
Senior debt repayment	50
Mezzanine debt repayment	1.8
Interest rate and retail price index swap breakage	27
Sub-contract breakage	0.2
Cash balances	(5.5)
Market value of equity	14.5
Transaction costs	1.0
Corporation tax gross-up	18.2
Total	107.2

Table 2| Cost comparison of terminating and continuing the PFI contract<sup>6</sup>

Cost components for each option	Estimate (£m)
<b>Terminating the PFI contract</b>	
Cash cost of local authority loan repayments from October 2014 to September 2038	180.46
Estimated cash cost of operating expenses from October 2014 to September 2038	36.58
Total	217.04
<b>Continuing the PFI contract</b>	
Cash cost of PFI fees, October 2014 to April 2033	222.5
Estimated cash cost of operating expenses, April 2033 to September 2038	8.8
Total	231.35
<b>Cost saving of termination</b>	14.3