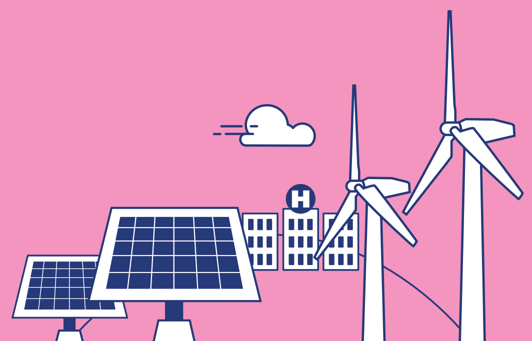
COMMERCIAL APPROACHES

- Finance and Balance Sheet Treatment
- Procurement and Contracts



COMMERCIAL APPROACHES

Finance and Balance Sheet Treatment

KEY FEATURES

- Funding options are available for most energy projects
- Funding can be on- or off-balance sheet
- Capital charges and depreciation need to be taken into account
- NHS capital is cost-free but still incurs capital charges and depreciation
- Private sector capital options are varied and risk-based

1. Project funding

Project funding can be a complex area and many aspects might not be obvious at the outset. Access to funders and funding can depend on the scale of the project, how it is being procured and contracted, whether or not it will be on the Trust's balance sheet, the financial stability of the Trust itself and (in the case of Salix funding) the level of carbon savings generated.

The good news for NHS Trusts wishing to proceed with an energy project is that there is almost always a cost-effective route available, even if the Trust has entered special measures.

It is important to ensure that all financial factors in the business case are considered, to ensure an apples-for-apples comparison between the options. The table below shows a summary of the main sources of finance and the key differentiators.

Funding option	Comment	Balance sheet treatment	Cost
Trust own capital funding	Very limited availability, usually deployed for clinical services or critical estates backlog	On balance sheet	No cost of finance but Trust pays 3.5% capital charge and depreciation
Department of Health Grants	None currently available for energy projects, however some grants available where Trusts are merging or have specific estates issues	On balance sheet	No cost of finance but Trust pays 3.5% capital charge and depreciation
Independent Trust Financing Facility (ITFF)	Currently our understanding is the ITFF do not have any funds available for Trusts pursuing energy projects	On balance sheet	No cost of finance but Trust pays 3.5% capital charge and depreciation.
Salix finance	Interest free government loans for energy projects. Projects must meet specific criteria and loan paid back in 4 years. For large projects this can cost the Trust more in the first 4 years	Off balance sheet	No cost of finance but Trust pays 3.5% capital charge and depreciation. CEF analysis shows this is broadly comparable to 3rd party off-balance sheet funding except it impacts prudential borrowing limits
Contractor funding	Provided by contractor, where they have in-house financing arrangements	On or off balance sheet	Typically 7%-15% depending on contractor. No capital charges if off balance sheet
CEF third party funder	Market tested for value for money for each project. Best rate with CEF 'Bankable' contract and deal-flow	Off balance sheet	Typically 4%-6% depending on funder. No capital charges if off balance sheet
Hybrid of two or more of the above	The CEF will work with any finance source or a combination of sources as best suits the Trust's requirements	On or off depending on configuration	Depends on hybrid combination

2. Key considerations

Important factors that need to be considered when completing the Value for Money exercise and reviewing options for funding are described below.

Capital Department Expenditure Limit (CDEL). CDEL is the amount of capital spend a Trust can make, including expenditure incurred in relation to finance leases and is reported to the Department of Health annually. The limit and management varies between type of NHS body - NHS Trusts and Foundation Trusts in financial distress have to work to delegated limits for capital investments. If a Trust or Foundation Trust is in a strong financial position, additional on-balance sheet debt may not be an issue. However, if the provider is already at its CDEL limit, it will not be able to take on any further on-balance sheet funding.This will automatically disqualify finance options, which by their nature must be held on the Trust's balance sheet.

Public Dividend Capital or Capital Charges. Where a project is on-balance sheet, the project must also allow for the cost of capital charges, calculated at 3.5% per annum on the providers average net relevant asset balance which includes annual depreciation adjustment. These charges should be included in the cost of a project. It should be noted that this accounting methodology is specific to the NHS as a means of managing cash within the national health economy and not seen in other parts of the public sector.

Control Total. The annual Trust financial target (control total) is set in advance of a financial year and must be achieved to unlock access to national funding and other financial benefits applicable to all NHS providers (trusts and foundation trusts). Access to national sustainability and transformation funding is conditional on providers agreeing and delivering their control total; which includes the annual repayment of PDC.

Interest rate. The lower the interest rate, the lower the cost of the project over time and the better the net savings. However, the best interest rates can come with conditions, such as needing a bankable contract or being on-balance sheet, which then attracts capital charges.

Bankability of contract. There is a wide variety of contracts available for energy projects in the NHS, presenting a wide range of risk for potential lenders. Bankability refers to the lender's confidence to fund a contract. Where a contract is well developed and has a good track record in the market, funding rates will be low, since the investment carries a very low risk, and the funder will have certain controls enabling it to manage any issues that could change the risk profile.

3. Funding through NHS capital

The Trust will have several options available to fund its energy projects. It can use NHS money such as its own cash, grants, or borrowing from the Independent Trust Financing Facility (ITFF).

Trust's own cash. The Trust may have cash in the bank that it has generated from its operating activities, or it has a capital budget. This money is not free, as it will attract capital charges at c.3.5% and the capital amount will need to be depreciated. It will impact on the balance sheet, and therefore the Trust's ability to borrow capital for other activities.

Independent Trust Financing Facility (ITFF). A Trust can make an application for capital from the ITFF. This capital attracts an interest payment and the capital is repaid like a traditional loan. It is on-balance sheet and will therefore impact the Trust's borrowing limits and is also be subject to capital charges.

Public Dividend Capital. The government may issue new public dividend capital as a way of giving finance to NHS trusts which is not treated as debt in the same way a loan is. A provider may apply through the ITFF or NHSEI. There is no repayment on the capital received however, the transaction is on balance sheet as a relevant asset and therefore attracts annual capital charge, currently at 3.5%, on the Trust's average net relevant asset balance.

Grants. Occasionally the NHS will create a pool of capital that is to be used for energy reduction projects in response to the national obligation to reduce carbon emissions and so it is worth investigating this possibility. Depending on how the grant is set up, it may attract capital charges too, through its Department for Business, Energy & Industrial Strategy.

4. Funding through private sector capital

In addition to NHS capital, a Trust has other methods for funding its energy project in the form of private sector capital.

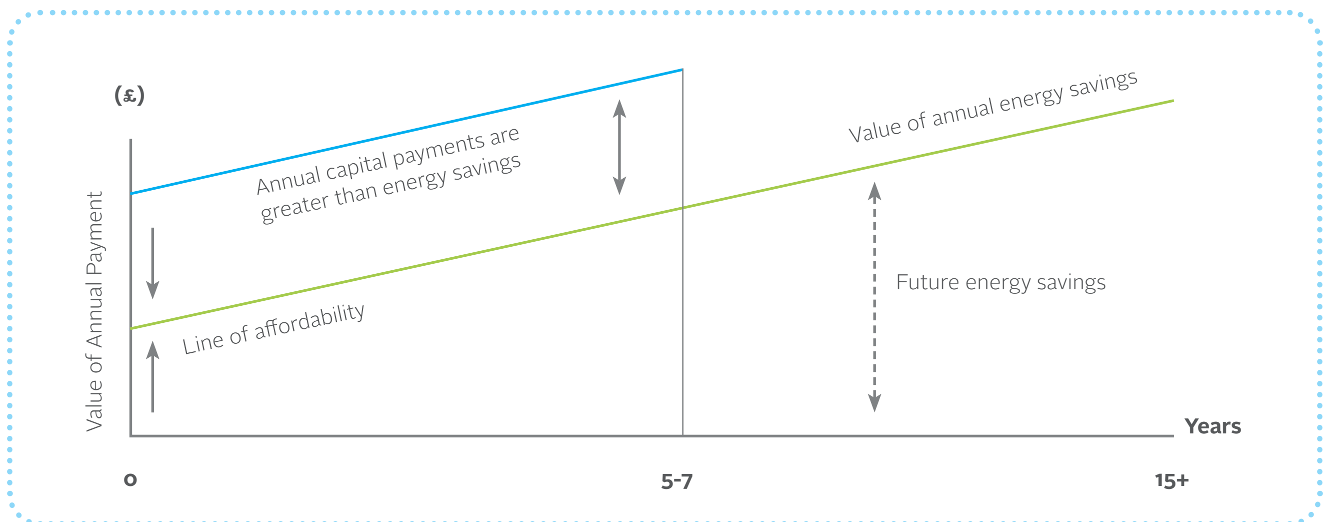
Finance Costs	Construction	Equity	Due Dilligence	Legal Fees	Post PC Debt	Term	Suitable for Small Projects
Project Finance	6%-8%	10% to 12% IRR	£150,000 plus	£30 to £100,000	6% to 8%	10 to 30 years	No
CEF Finance	2.5% to 4.0%	Not required	Nil	£30 to £40,000	4% to 6.0%	7 to 30 years	Yes
High Street Lenders	No	Not required	Risk averse/NA	£30 to £40,000	8% to 10%	5 to 7 years	Yes
Equity	10% to 12% IRR	Not required	£150,000 plus	£30 to £40,000	10% to 20% IRR	5 to 7 years	Yes but needs high yield

As a demonstrable Value for Money proposition, the NHS has been funding projects in this way for many years and it is accepted by NHSI and others as a way of making energy projects happen. When considering private sector capital, the structure of the deal and the source of finance will significantly impact on the price of finance and therefore on project viability. Professional advice should be sought and the Trust should seek prior approval from NHSE/I DHSC but the previous table provides an indicative example.

As can be seen, not all finance is the same. Lenders will assess the project risk and allocate a cost of finance and the level of due diligence required to mitigate that risk. The contract that is used, the way the payments are allocated, and whether the project is on- or off-balance sheet for the Trust will impact on that perception of risk. A contract needs to be bankable, i.e. can be approved by a lender's credit committee. A Trust can obtain private sector capital by going directly to a lender, via a framework or, if it is able, via an energy company.

5. Interest free loans

In October 2020 the Government, through its Department for Business, Energy & Industrial Strategy, released the Public Sector Decarbonisation Scheme (PSDS) to be managed by state owned Salix Finance Ltd. This scheme is open to the full public sector and made £1bn of grants available under very specific conditions relating to carbon reduction and infrastructure investment. It also set strict application and programme delivery timelines. A material benefit to qualifying NHS providers is that capital investment is not a relevant asset under PDC rules and therefore introduces cash into the system at no cost. In addition to the PSDS Salix Finance Ltd provides interest-free Government funding to the public sector to improve their energy efficiency, reduce carbon emissions and lower energy bills. Salix is funded by the Department for Business, Energy and Industrial Strategy, the Department for Education, the Welsh Government and the Scottish Government. It was established in 2004 as an independent, publicly funded company, dedicated to providing the public sector with loans for energy efficiency projects.



Salix loans are interest-free but on-balance sheet, impacts on borrowing and attracts capital charges that need to be considered. Salix has only had limited use in the NHS, as it requires fast payback periods on the limited specific technology it can support. The capital itself typically needs to be repaid in 4 to 5 years, which makes it difficult to achieve savings in year one.

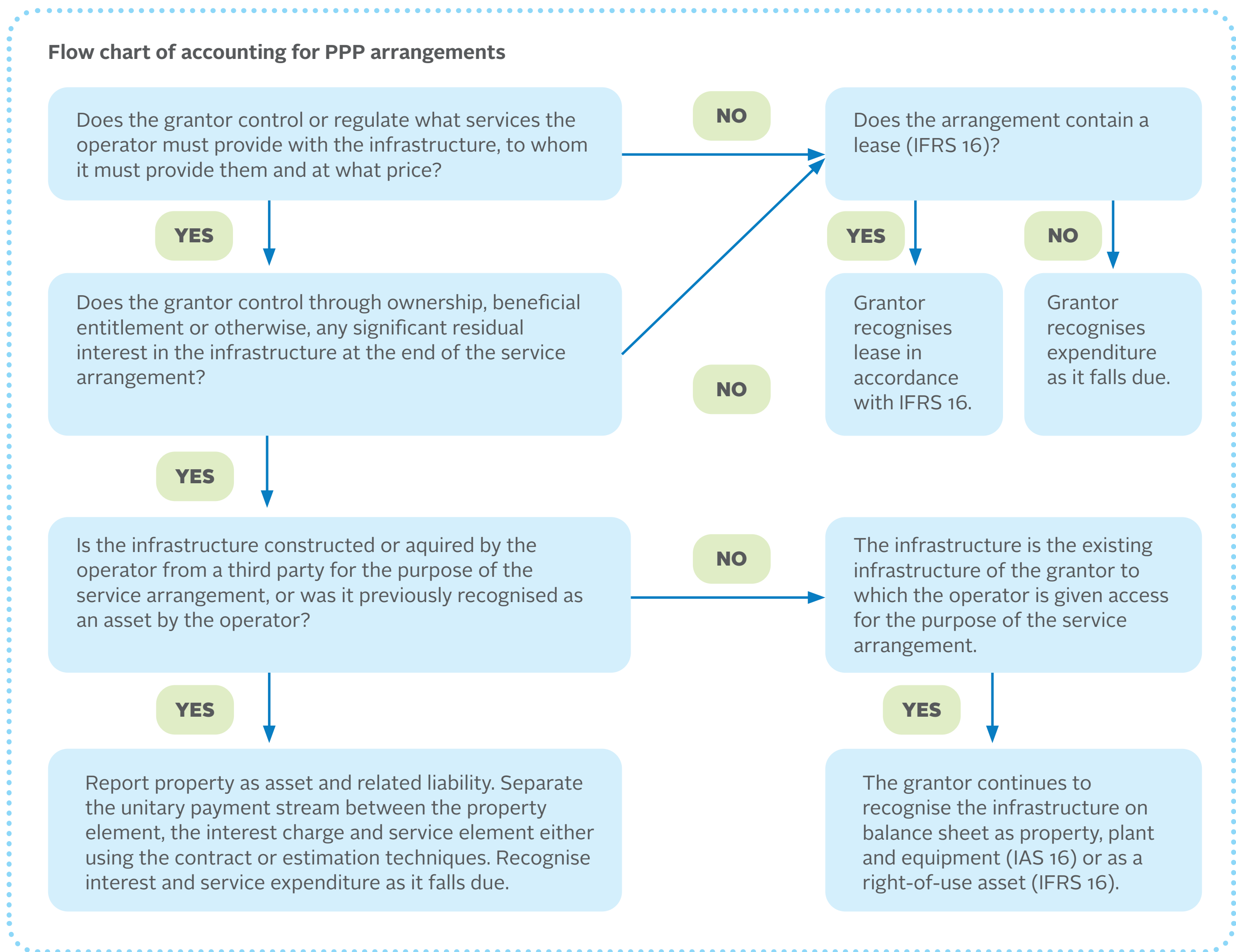
6. Finance terms and payment profiles

Whatever the length of an agreement, the amount of savings that can be achieved per annum will stay the same, but the amount of interest and capital to be paid back each year will change depending on the financial term.

As a simple example, if the capital required is £100 and the energy savings are £20 p.a., then there is a simple payback of 5 years. If the loan must be repaid in 4 years, then £100/4 = £25, which is greater than the savings p.a., so the project is not viable. If the £100 required is borrowed over 15 years, the annual payments would be £15 p.a., so with an energy saving of £20 p.a. the Trust would achieve a saving of £5 pa. This is further complicated, of course, when interest is added.

7. Balance sheet treatment of infrastructural assets or their usage

It is important that estates directors and engineers leading energy projects are familiar with and understand balance sheet issues, since Energy and infrastructure projects that make big inroads to backlog maintenance and generate large volumes of savings normally deploy the appropriate amount of capital, and this can have a significant effect on the balance sheet of some or all of the parties involved including (for health) the DHSC, NHS, the Trust, Integrated Care System (ICS , contractor, funder and even the nation.



A typical simple energy project might involve £5m of capital for a basic Energy Performance Contract rising to £10m or £15m if the project is designed to have a material effect on the Trust's journey to net Zero carbon. It is a fact of accounting that even when the capital deployed is procured by a contractor at their own risk, that accountants see this as a lease and thus creating an asset for the Trust. Trust capital expenditure is counted towards its, or the ICS delegated capital limits (Cdel), and because Cdel is limited, ultimately by Treasury, it means that any expenditure on energy schemes that creates an asset reduces the remaining available Cdel for clinical and other uses. So a Trust investing £5m into its infrastructure will use up some or all of its Cdel limit, potentially restricting other investments, for example, a clinical upgrade.

Additionally a NHS Trust using Cdel will be subject, at the very least, to capital charges at 3.5% of the amount of Cdel deployed. Even though Trusts typically spend all their Cdel, some prefer not to spend Capital Charges "revenue" on energy projects if it can be avoided.

Public bodies in Wales, Scotland, Ireland and Northern Ireland also all have additional and differing reasons as to why they wish to restrict the value of assets on departmental, and thus the national balance sheet. Since the collapse of Carillion suddenly placed a large set of assets on the DHSC balance sheet, the issue has received a lot of attention from DH SC in England too. Estates departments have historically found it much easier to get infrastructural projects approved by their Trust Boards if they could show that not only are they self funding through savings, but that they also have no impact on Cdel through being off balance sheet.

Prior to the introduction of IFRS 16 most EPCs were viewed as operating leases and many were classified as off balance sheet. From the 1st April 2022, it is proposed that all leases above a certain value or with more than a year to run will be on-balance sheet under International Financial Reporting Standard 16 (IFRS 16), so Trusts wishing to have their projects off-balance sheet will need to use a contract that has been very carefully constructed to be off-balance sheet and this is possible under the current Consolidated Budget Guidance (CBG). At this time the approach is not acceptable to DHSC under the guidance issued at the same time as the current CBG by Treasury and which does allow this approach.

IFRS16 does allow an alternative approach to traditional lease accounting, whereby the Trust places the lease as an asset on its balance sheet, but offsets it with the liability associated with the EPC. This might not reduce the Cdel impact but will Impact on the capital charges due. The Financial reporting Manual contains the diagram on the previous page by way of explanation.

Contracts that are Service Contracts do not affect balance sheet, but may well attract significant accounting scrutiny. Traditionally a catering contract could include a refurbishment of a Trust Restaurant or food trolleys and often these were not seen as on balance sheet, Laundry and maintenance contracts traditionally enjoy the same freedoms.

References

- *https://www.gov.uk*
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- *https://ec.europa.eu*
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