



Ensuring that key services remain viable

Improving the pricing of NHS services is essential to help commissioners make better decisions for their patients, and to ensure that hospitals and other providers of care are fairly reimbursed. These issues are discussed in depth in our report, [“An evaluation of the reimbursement system for NHS-funded care”](#). We will be working together with the NHS Commissioning Board to develop a pricing system that helps drive improvements in the quality and efficiency of care for patients.

Under any national tariff system, there could be some cases where providers face costs that are unavoidably above the level reimbursed through national prices. In cases where these services are valued by patients and are required by commissioners, it is important to make sure that they remain financially viable and that quality can be maintained. Under the new Health and Social Care Act, Monitor will have an important role in agreeing or determining local modifications of prices where, without that modification to the price set in the national tariff, the service would be uneconomic.

A consistent and transparent approach to local modifications

The reimbursement regime should not reward failure; high quality services that are efficiently provided and required by commissioners should be protected. But all too often providers with costs higher than revenues are supported by informal arrangements. These arrangements can be opaque and inconsistent, and may support low quality or inefficient provision.

Under the reforms, the approach that we take to approving uplifts to national tariff prices should be consistent and transparent. So, we commissioned Frontier Economics to help us develop a methodology to do this based on sound theory, evidence and regulatory best practice.

Locally-led and evidence-based process

Frontier proposes a “toolkit” approach to evaluate whether a local modification to the national tariff prices paid to a provider is warranted. This includes a number of tests, such as whether higher costs are unavoidable and material to the provider.

Frontier also supports the view that decisions should be made as close as possible to those affected by them. Agreements between providers and commissioners, which make use of detailed local knowledge, are likely to result in better decisions as well as reducing the regulatory burden on the system. As such, a key recommendation is that, where possible, we support and encourage local commissioners and providers to negotiate and agree modifications following national rules that Monitor sets. Any agreements will then be assessed and approved by Monitor. In exceptional

circumstances, should this constructive local engagement not work, providers will be able to apply directly to Monitor for a local modification, subject to the key tests being met.

We are already building on this proposal: our draft licence conditions set out a requirement for providers to engage constructively with their commissioners with a view to reaching an agreement.

The evolution of the system

At the moment, it seems common that losses in some services are cross subsidised by surpluses in others. Local modifications just to individual loss-making services in this environment could over reimburse some providers to the detriment of commissioners (since there is no equivalent adjustment to the surplus generating service). So the report suggests an additional 'whole provider test' during a transition period (until the scale of systematic cross subsidy has been suitably reduced) that will help ensure fair reimbursement at the aggregate level.

The need for workable arrangements

We are seeking views on this work by Frontier, particularly around the principles and approaches set out in the report. This is to make sure we design a system that is both sound and practical and meets the needs of the sector. We will be developing and consulting on specific proposals later in the year taking into account the report and your comments.

A number of questions are set out below and we welcome responses on these, and on the proposed approach more generally.

A handwritten signature in black ink, reading "Adrian Masters". The signature is fluid and cursive, with a long horizontal line extending to the right from the end of the name.

Adrian Masters

Director of Strategy

How you can respond

Monitor welcomes comments on this report. In particular:

1. Do you have any comments on the criteria for a good framework that Frontier set out in the introduction to the report?
2. Do you agree that, where possible, any local modifications should be arrived at by negotiation and agreement between the commissioners and providers of services? In addition to the licence condition on constructive engagement, do you have any suggestions on how Monitor can encourage agreements?
3. What are your views on using the 'whole provider' analysis during a transition period?
4. Do you have any comments on the proposed components of the 'long-term toolkit' (structural difference, benchmarking, quality and wider implications tests)?
5. Do you agree that Monitor should rely on a complaints system, rather than monitoring providers' compliance with the conditions of a local modification?
6. Do you have any comments about the practicality of implementing the different parts of the framework?

Please send your answers and/or general comments to pricing@monitor-nhsft.gov.uk or complete the online response form [here](#) on our website.

If you do not have internet or email access please write to: Pricing, Monitor, 3rd Floor, Wellington House, 133-155 Waterloo Road, London, SE1 8UG.

This document was published on Tuesday 3 April 2012. Please submit your responses to the questions and any other comments that you have by **5pm on Friday 1 June 2012.**

Please note that we may use your details to contact you about your responses or to send you information about our future work. We do not intend to send responses to each individual respondent. However, we will analyse responses carefully and give clear feedback on our website and through other channels later in 2012 on how we have developed our approach to pricing as a result.

You can sign up to receive emails when we publish information on pricing, and on our proposed new role in general, [here](#) on our website.



A methodology for approving local modifications to the national tariff

A report prepared for Monitor

April 2012

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Executive summary

Executive summary

Overview

Under the Health and Social Care Bill, Monitor will become sector regulator for health.* The Bill requires Monitor, as part of its new role, to set out a methodology for approving local modifications to the national tariff. Frontier has been commissioned by Monitor to develop proposals for the local modification methodology.

The national tariff sets a price which is paid to providers for delivering health services to NHS patients. Where a particular provider believes it can no longer provide certain services, because they are uneconomic, it may be appropriate for Monitor to approve a local modification to the national tariff for that provider.

Local modifications are one small part of a system of reimbursement for NHS services, and are intended to complement (rather than replace) existing reimbursement mechanisms. Monitor and the NHS Commissioning Board will be jointly responsible for development of the reimbursement system as a whole, including the introduction of the local modification methodology set out in this report.

Local modifications should be the exception rather than the rule. They are not intended to subsidise poor quality or inefficiency. They should be used to ensure that services which are valued by patients, and are of a high quality, will be sustainable. Patients will benefit from this system, since it will ensure continuity of services they value. And developing a more transparent, compliant reimbursement system will allow more effective regulation of NHS services.

A central theme of this report is the emphasis Monitor should place on providers and commissioners taking responsibility locally for ensuring services remain economic. It should be up to providers and

commissioners to agree whether a local modification is required for a service to remain sustainable, and what services should be provided in the best interests of local NHS patients. Monitor should decide whether to allow modifications on the basis of the evidence provided. Monitor should provide support and guidance to assist providers and commissioners in developing their capabilities in this respect.

This report provides a recommended methodology for assessing whether or not to allow a local modification. We also outline some practical issues for implementing the recommended methodology.

Our process

We began collecting evidence and developing recommendations for a local tariff modification methodology in September 2011. A key part of our process was to ensure we consulted with sector experts and relevant stakeholders.

Monitor intends to be a strongly evidence-based regulator. We therefore incorporated a wide range of views and received input from across the sector. We received input from:

- a range of providers across acute; community; and mental health services;
- commissioners;
- the Care Quality Commission (CQC); and
- clinicians.

We held two stakeholder workshops during which our early proposals were discussed and developed. In addition, we held independent discussions with stakeholders and experts from both the health sector and other regulated sectors.

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Figure 1. Stakeholders consulted as part of our review

Government and regulatory stakeholders:	
<ul style="list-style-type: none">• Care Quality Commission• Department of Health• HM Treasury	<ul style="list-style-type: none">• Newcastle Hospitals NHSFT• NHS East of England• Northumbria Healthcare NHSFT• Sussex Partnership FT
Providers and commissioners:	
<ul style="list-style-type: none">• Bridgewater Community Healthcare NHS Trust• Central London Community Healthcare NHS Trust• Doncaster and Bassetlaw Hospitals NHSFT• Foundation Trust Network• Guy's and St Thomas' NHSFT	<ul style="list-style-type: none">• University College London Hospitals NHSFT
	Independent experts:
	<ul style="list-style-type: none">• Dr Mark Charny, Translucency Ltd• Dr Thomas Mann, Direct Health First• Professor Catherine Waddams, University of East Anglia

Source: Frontier Economics

Context

As specified in the Health and Social Care Bill, local modifications may either be in the form of:

- an **Agreement** between a commissioner and provider, in which both jointly propose a modification to the national price; or
- an **Application** from a provider, if it has failed to reach an agreement with its commissioner.

In either case, Monitor must decide whether to approve the local modification, although under an application Monitor will determine the appropriate form and size of the modification, whilst under an agreement this is specified jointly by the provider and commissioner.

In order to approve a modification, the Bill states that Monitor must determine that, absent the modification, it would be “uneconomic for the provider to provide the service for the purposes of the NHS”.

Why are local modifications needed?

At present, the revenue providers receive for some services is not

sufficient to cover the costs incurred in providing those services. In other words, there is a “revenue gap” for delivery of some services, which threatens their sustainability.

For the purposes of local modifications, there are two primary drivers of a revenue gap. Either:

- the costs of providing the service are too high; or
- the revenues generated by the service are too low.

Local modifications should ensure that cost-effective services, which are highly valued by patients and meet essential standards, remain sustainable. As such, a modification can only increase prices; price reductions should not be made through a local modification.

Commissioners will be required to fund local modifications out of existing budgets, at least in the short run. Commissioners are best-placed to determine how best to allocate budgets against local priorities. Over time, it may be appropriate for commissioning allocations to evolve to reflect changes in local prices.

Developments in national tariff

Local modifications can be made for national tariff services where there is a centrally determined price. As the baseline against which local modifications will be made, it is important to understand what changes can be expected in the national tariff system.

The national tariff may develop in numerous ways, including the likelihood that new services are brought within the tariff system. We believe the most pertinent potential change is the likelihood of an increasingly cost-reflective pricing system.

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Whilst we expect tariff to become more cost-reflective, it is also clear that this will be a long process. There will be a transition period during which tariff will remain imperfect. As described below, tariff inaccuracy will have implications for local modifications. We have therefore made specific recommendations for the transition period.

Roles and responsibilities

There could be significant benefits from providers and commissioners negotiating and agreeing on local pricing issues. We therefore recommend that Monitor's local modification methodology embeds a 'light touch' approach, which encourages providers and commissioners to take responsibility for local pricing. As far as possible given its statutory duties, Monitor should effectively act as an appeals body, rather than an interventionist regulator.

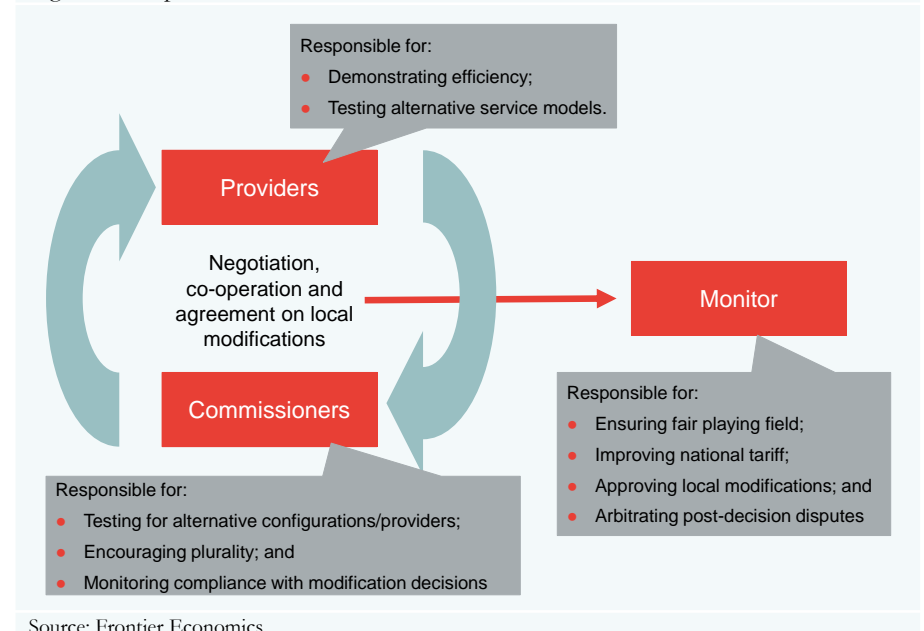
An overall vision for where roles and responsibilities should lie for local modifications is set out in Figure 2.

Figure 2 highlights that providers and commissioners should largely be responsible for developing proposals for local modifications. As such, providers and commissioners should be expected to jointly develop initial proposals for a modification through cooperation and agreement.

Monitor should approve modifications only if they are clearly supported by a robust evidence base. This report outlines the evidence Monitor should require in order to approve a modification. This report should also help providers and commissioners to understand the types of evidence to consider when negotiating and agreeing local modifications.

While Monitor should not prescribe precisely how their proposals

Figure 2. Responsibilities for local modification



are justified, providers and commissioners should be required to demonstrate that the relevant concerns and issues highlighted in this methodology have been addressed.

Overview of the methodology

We have recommended a methodology comprised of four main components. The components of the toolkit are:

- a **structural difference test**, to determine the cause of the revenue gap, and to understand whether it warrants a local modification;

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- **benchmarking** to identify the extent to which the revenue gap is driven by inefficiency, and therefore to measure the appropriate size of the modification;
- a **quality test** to ensure that a modification is not being requested to sustain poor quality services, or as an incentive to improve quality; and
- an assessment of the **wider links and implications** of a proposed modification.

Figure 3 sets out a high-level overview of the key components of the recommended local modification methodology.

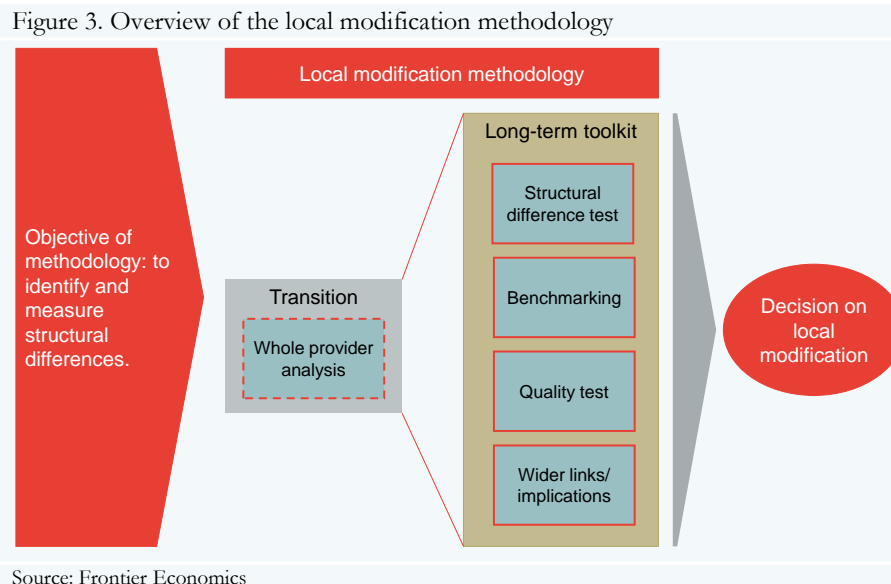


Figure 3 also highlights that, in addition to the four components of the methodology described above (the “long-term toolkit”), we have recommended an additional stage of analysis, applicable only in a transition phase.

The analysis required for each of these components should be undertaken primarily by providers and commissioners. Monitor should review this evidence, and may supplement it with its own analysis.

Structural differences

The Bill permits modifications in cases where a service would otherwise be uneconomic.

Monitor should therefore approve a modification to the national tariff if and only if it is convinced that the commissioner and provider in question can demonstrate that:

- structural differences are causing the service to be uneconomic; and
- alternative options have been tested but ruled out as unviable.

The requirement for commissioners and providers to test alternative options should be substantial. This is discussed more in the box on the following page.

Monitor cannot determine what factors will or will not be deemed structural *per se*. Whether or not a particular factor is structural must depend on the particular characteristics of the provider.

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We have therefore recommended a test against which any specific factor can be deemed structural or not structural. Structural causes of a revenue gap must be:

- unique to the provider;
- beyond the control of the provider (and commissioner); and
- material enough to threaten continuity of service.

Each of these conditions, and how providers and commissioners may demonstrate that they have been satisfied, is described in more detail below.

Unique

Local modifications should only be made in cases where no other form of reimbursement is already made (or available). In principle, cost drivers which are common to most other providers should be adequately reimbursed by national tariff. For example, allowance is made in national tariff for specialist provision, and for expected variation in local costs (via the Market Forces Factor).

Uncontrollable

Even if a cost driver is unique, for Monitor to determine that it represents a structural difference it must also be beyond the control of the provider (and commissioner). For example, contractual arrangements might be unique to a provider but could usually be renegotiated. The configuration of services can often be modified by a provider, or jointly with a commissioner.

To allow a modification, Monitor must be convinced that:

- alternative options have been explored;
- the cost driver is not temporary; and
- there is a genuine constraint on removing the cost driver (e.g. the cost of reconfiguration, or a contractual commitment).

Material

Monitor should only approve a local modification if it is convinced that the identified cost driver is likely to make the service uneconomic. In other words, if a service, when considered in isolation, would not be sustainable at current costs and funding levels, it would potentially warrant a modification.

Requirement to test alternative models

Before a local modification will be approved, a provider should demonstrate that alternative options (which eliminate the need for a modification) have been tested and shown to be inappropriate. This should include consideration of alternative models of provision, and learning from current best practice and recent innovation.

In addition, commissioners should demonstrate that alternative providers and service configurations have been considered. This could also include competitive tendering for services. This sort of market testing could help to determine whether a modification is necessary for the service to be sustainable.

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Benchmarking

The purpose of a local modification is to ensure that cost-effective, highly valued services are remunerated appropriately.

It will therefore be important for providers and commissioners to provide evidence which allows Monitor to identify in each case:

- how much of the revenue gap is driven by structural cost differences; and
- that the revenue gap is not the result of inefficiency in how the service is provided.

A large number of potential approaches to comparative analysis exist.

We recommend that operating expenditure (opex) benchmarks are undertaken as standard under the local modification methodology. This approach assesses costs such as staff, materials and administration to check that they are reasonable in comparison with other providers. These types of costs represent a large proportion of total costs in the health sector.

This analysis should then be supplemented with any additional analysis Monitor considers relevant given the specifics of each case, and the structural cost difference being assessed.

It is clear that benchmarking in the health sector will represent a significant challenge for providers and commissioners, and for Monitor. It would therefore be pragmatic for Monitor to consider any type of comparative cost-effectiveness analysis that might be undertaken by providers or commissioners as evidence to support a local modification.

Quality test

Monitor's primary statutory duty is to protect and promote the interests of patients by promoting provision which "maintains or improves the quality" of services.

Given the links between costs and quality, it is important to incorporate an assessment of quality in the local modification methodology. Monitor should have regard to two principles:

- First, a local modification should not be used to sustain a poor quality service. Monitor should encourage providers to improve the quality of services, but it should be the responsibility of the provider (and commissioner) to fund such improvements out of existing budgets.
- Second, a local modification should not be used as an incentive to improve quality (this should be achieved through other levers within the national tariff). Local modifications are intended to ensure that services do not become uneconomic, and thereby guarantee continuity of service.

Providers and commissioners will be able to draw on a range of sources to evidence that essential standards are met. The most readily available, and standardised, source is likely to be the CQC's quality assessments. These are available for all NHS providers, are updated annually, and contain data at the level of individual services.

In addition to this CQC evidence, providers and commissioners may also draw on their own quality measures, so long as the use of such measures is transparent and justified.

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Cross-checks and wider implications

Local modifications are likely to have implications beyond the financial impact on providers and commissioners. Monitor will therefore need to understand what the implications of any proposed modification are, to ensure that allowing such a modification would be consistent with its statutory duties.

Central to this element of the toolkit is the impact that a modification might have on competition and plurality of providers. Pricing decisions for a specific provider could potentially impact the entry decision of an alternative provider, if the potential entrant would not also benefit from the modification.

Monitor's assessment of competition must be consistent with precedent set out by the Co-operation and Competition Panel (CCP) and under the Principles and Rules for Cooperation and Competition (PRCC). We also recommend that a complaints mechanism is set up to act as a backstop, in order that unforeseen consequences of a decision can be appealed (potentially to the CCP).

Transition

Local modifications are intended to account for structural differences which lead to costs exceeding national tariff revenues for a particular service. However, one reason that a revenue gap might exist is that the tariff itself is inaccurate.

Currently, some tariffs are “too high”, while others are “too low”, relative to the costs of provision. For many providers this evens out across the range of services provided. But when looking at a specific service in isolation, this may distort the assessment of sustainability.

The implication of tariff inaccuracy is that it may be appropriate, during a transition phase, to include an assessment of a provider's financial health at a more aggregated level. The purpose of this assessment is to identify whether the revenue gap for the service of interest is being offset at the provider level, and if so to distinguish between:

- offsetting through “high” tariffs for other services being provided; and
- offsetting through revenues generated by cost-effective provision of other services.

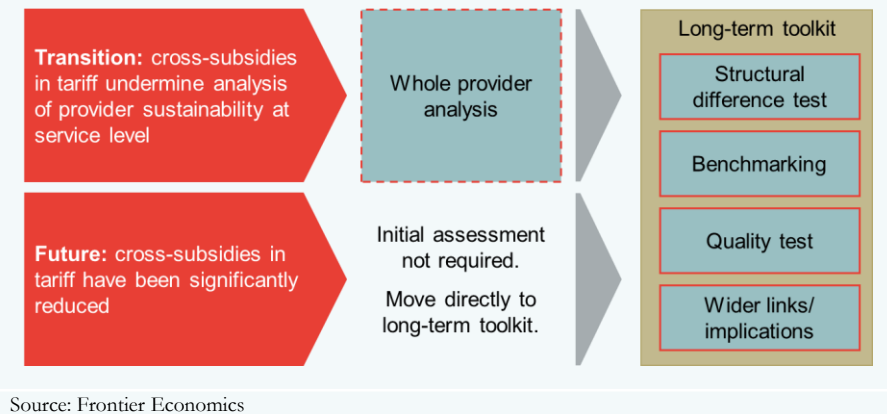
In the latter case, were Monitor to reject a modification for the service of interest, this would effectively “penalise” the provider for cost-effective performance elsewhere. The transition period assessment is designed to ensure that no such penalty is imposed.

The whole provider analysis therefore allows Monitor to ensure that local modifications are only approved in cases where:

- the provider is not sustainable at an organisational level, but would be sustainable if a local modification is approved; or

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Figure 4. Transition period assessment



Source: Frontier Economics

- the provider is sustainable at an organisational level, but only because cost-effectiveness in providing other services is cross-subsidising the service of interest.

This transition analysis allows Monitor to prioritise local modifications which are most likely to be valid, whilst ensuring the incentives for provision of high quality, cost-effective care are not undermined.

The “long-term toolkit” is then required to assess whether a local modification is justified. This toolkit should always be applied before any modification is approved.

As national tariff evolves, the whole provider analysis may not be required. As existing inaccuracies in tariff are reduced, it will be possible to assess a local modification for a particular service “in isolation”, without needing to consider possible offsetting effects of tariffs for other services.

Agreements and applications

Providers and commissioners should largely take responsibility for agreeing local modifications. A preference for agreements over applications is also implied by the wording of the Bill. However, Monitor should have regard to its statutory duties and should not allow an agreement if doing so would not be in the interests of patients.

For any given modification, it is likely that an agreement will deliver better outcomes than an application. The likely benefits include:

- better information revelation;
- a better balance of incentives between parties;
- reduced regulatory burden;
- positive externalities from increasing engagement; and
- behavioural incentives.

These benefits will accrue to all relevant parties: Monitor; the negotiating parties; and most importantly patients, since commissioners are best placed to ensure that the services most valued by local populations remain sustainable.

Notwithstanding the likely benefits, an agreement could be rejected. We believe there are three broad reasons Monitor might reject an agreement:

- it is not demonstrably in patients’ interests;
- it manifestly fails to pass an element of the methodology; or
- it is significantly detrimental to third party interests.

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Implementing the methodology

The methodology described in this report should be developed further by Monitor, to ensure that it is:

- understood, accepted and supported by providers, commissioners and other stakeholders; and
- consistent with Monitor’s broader objectives, and particular policies, as these are developed as part of Monitor’s transition to sector regulator.

In particular, at the heart of the methodology we have recommended is the structural difference test. This should be refined jointly by Monitor and providers and commissioners to ensure it is well understood. To enable providers and commissioners to reach agreement on local modifications, and to present a clear and well evidenced case to Monitor for approval, it is essential that the tests of “unique”, “uncontrollable” and “material” are defined clearly.

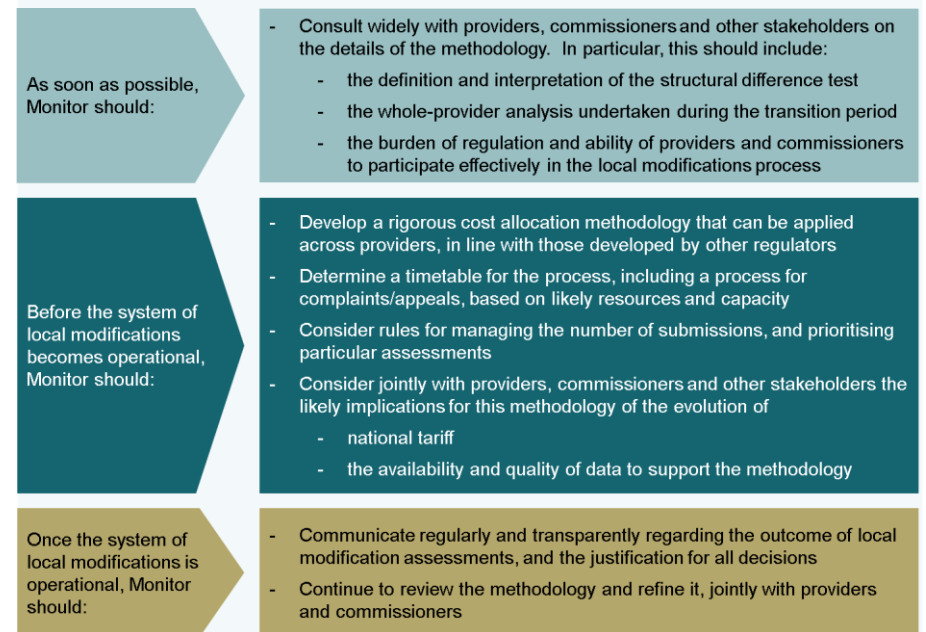
This development of the methodology should continue as applications for local modifications are submitted and assessed. It is highly likely that these definitions, tools and evidence base will improve as cases are reviewed. Monitor should respond accordingly, by refining the methodology in a clear and transparent way. This is consistent with regulatory best practice.

In addition, in order to ensure that the methodology delivers robust and fair results, it will be important to ensure that providers and commissioners are given the right incentives to engage proactively in the process and collaborate effectively.

Summary of next steps for Monitor

This report suggests a number of next steps that Monitor should take forward. These are summarised below, alongside an indication of the timetable against which Monitor could develop them.

Figure 5. Summary of next steps for Monitor



Source: Frontier Economics

Most importantly, we recommend that Monitor continue to consult widely on the details of the methodology provided in this report. This will enable Monitor to develop the methodology with the input of all relevant stakeholders and to implement it with the support of a robust and reliable evidence base.