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Health Finances

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I have prepared this report for presentation to the National Assembly under section 145A of the Government of Wales Act 1998.

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Report presented by the Auditor General for Wales to the National Assembly for Wales on 12 July 2012

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Summary

1 Our report, *A Picture of Public Services 2011*, identified the significant financial and operational challenges facing the NHS in Wales. That report showed that the NHS in Wales faces a tougher financial settlement than the other three countries in the UK (further detail on the comparison to the rest of the UK can be found in *A Picture of Public Services 2011*). And it faces a significant and growing gap between the funding it needs to meet known cost pressures, and the actual funding it receives.

2 This report provides a more detailed assessment of the financial position across NHS bodies, and the financial challenges that the NHS faces. It analyses:

- historical financial data showing how the NHS has managed within its budget in the recent past;
- financial and other data showing how the Welsh Government and NHS bodies managed the financial pressures on the NHS in 2011-12; and
- the scale of the funding gap the NHS faces over the coming period, and the short-term and long-term challenges in light of the progress the NHS has made so far.

3 During the period covered in this report, the NHS in Wales has gone through significant structural change. On 1 October 2009, the system involving 22 local health boards commissioning services from nine NHS trusts came to an end. In its place, seven health boards are now responsible for planning and delivering healthcare services in seven regions. Two of the NHS trusts remain and are responsible for providing specialist services: the Welsh Ambulance Services NHS Trust and Velindre NHS Trust which provides specialist cancer services. There is also a new Public Health Wales NHS Trust. The changes in 2009 have seen the move away from a provider/commissioner system to a system based on integrated planning and delivery. In doing so, the Welsh Government intended that one of the benefits of this change would be to help to rectify some of the historic problems of financial planning and management in the NHS that we highlight in this report.

4 This report covers the period from 2006-07. During that period, the NHS bodies have worked within two sets of accounting rules, depending on whether they are a trust or a health board. One of the key financial requirements for health boards is the statutory financial requirement to break-even each and every year. Where they do not achieve break-even, their excess spend is deemed to be 'irregular' and the audit certificate on their financial statements would reflect this by receiving a 'qualified' regularity audit opinion. A qualified opinion could in turn impact on the audit opinion on the Welsh Government's financial statements. For NHS trusts, the statutory requirement is to break-even, taking one year with another. However, the Welsh Government also requires them to break-even each year within a certain threshold of flexibility, and unlike health boards, any overspend within these thresholds is not deemed to be 'irregular' spend.

5 It is important to note that this report is primarily based on an analysis of the NHS financial position. The report is not intended as a detailed review of financial management across the NHS, nor is it intended to provide an evaluation of the impact of the structural changes in the NHS in recent years.

6 The key message from this analysis is that with the NHS and other public services facing unprecedented financial challenges, the historical patterns of the Welsh Government providing NHS bodies with additional money during the year to manage deficits is not sustainable. In recent years, the Welsh Government has worked with NHS bodies to improve cost control and make savings but more radical changes to health services are needed to ensure the NHS in Wales is financially sustainable.

In the past, despite rising budgets, improved financial monitoring and a greater focus on cost savings, NHS bodies have required additional year-end funding to break-even

7 The detailed flow of finances through the NHS in Wales is complex, but there is a simple overall framework. To start, the Welsh Government determines what proportion of its budget it will spend on health. The health budget is currently managed by the Welsh Government's Department of Health, Social Services and Children (the Department). The Department allocates the vast majority of the health budget to the individual NHS bodies to provide health services to the people of Wales. The NHS bodies are themselves responsible for managing the funding allocated to them and ensuring it is properly allocated to deliver health services.

8 Between 2006-07 and 2010-11, the Welsh Government's budget for health services in Wales rose every year as did the funding allocated to NHS bodies. Although the budgets rose each year, the NHS bodies have needed additional funding in order to break-even. Between 2006-07 and 2008-09, the Welsh Government provided additional funding to support service improvements in local NHS bodies by using underspends and contingency funding within its own central programme budget. However, in 2009-10 and 2010-11, the Department needed additional funding from central reserves (funding held within the Welsh Government's general reserve as yet unallocated to any specific department) in order that the overall health budget and local NHS bodies could break-even.

9 One of the major challenges in a service that is demand-led with increasing pressures is to establish a culture of cost control. At the start of each year, the Department sets out a clear requirement for NHS bodies to plan and manage within available resources whilst meeting agreed targets. Yet by the end of each year, the Welsh Government has provided additional funding to support service improvements and cover local deficits. The Welsh Government is under pressure to cover those deficits in part because accounting rules mean that its own accounts could be qualified as a result of overspends at one or more NHS body (see Paragraph 4).

10 The provision of additional funding makes it more difficult for local finance managers to emphasise the need for cost control to clinicians and operational staff, who may assume that funding for budget overspends will be found elsewhere. The Welsh Government intended that the reorganisation in 2009-10 would help address some of the underlying problems of financial management. By removing the commissioner/provider

split, the Welsh Government anticipated that there would be clearer accountability for managing finances. The Welsh Government has strengthened its monitoring of individual NHS bodies' finances during the year, by introducing more detailed financial monitoring forms which provided consistent and timely information on the forecast and to-date position every month.

11 The Welsh Government and NHS bodies have also strengthened their focus on cost control. In 2010-11, the Welsh Government set local bodies very tough financial targets, while retaining some contingency in its central budgets. This approach successfully focused attention on reducing costs, with NHS bodies reporting £310 million savings that year. However, the tough message that no further funding would be forthcoming was undermined when the Welsh Government provided additional funding from its own contingency and from Welsh Government reserves. There is a risk that the approach used in 2010-11 exacerbated perceptions held by NHS managers and clinicians that the Welsh Government has a hidden contingency fund which it will use to address deficits.

In 2011-12, NHS bodies again reported significant savings, and the Welsh Government has sought to put health finances on a more sustainable footing that helps break the cycle of additional year-end funding

12 In 2011-12, the NHS in Wales faced its toughest year since devolution. Predicting the precise scale of the funding gap that the NHS faced is difficult as establishing the exact level of cost pressures on the NHS is complex and there are several different official assessments. Using those, and 2010-11 as a baseline, we estimated that there was a funding gap in the order of £280 million to £380 million at the start of the financial year.

13 By the end of the financial year, the overall health budget and all of the individual NHS bodies had broken even. In larger part, this break-even was achieved due to significant savings by NHS bodies. However, the Department also had to access additional funding from Welsh Government reserves in order to break-even.

14 NHS bodies reported making £285 million savings in 2011-12. The largest areas of reported savings were staffing, including management costs, procurement and continuing healthcare. NHS bodies reported that around 87 per cent of the savings were recurrent, which means they will be sustained in future years. While it is positive that the vast majority of savings are recurrent, the level of non-recurrent one-off savings increased towards the end of the year as some NHS bodies struggled to deliver sufficient savings. In particular, there was an increase in

one-off procurement and staff savings, which suggest some NHS bodies delayed necessary purchases and staff recruitment until the new financial year. Also, it is likely that some of the savings were reinvested, so may have been used to improve quality rather than to save cash.

15 The savings reported by the NHS were not enough to bridge the funding gaps. In July 2011, the Welsh Government agreed to provide an additional £93 million from central reserves of which £63 million would be recurrent (ie, it will be added to budgets for future years) to NHS bodies. A further £40 million was added from the Department's own budget, providing a total of £133 million. An additional £12 million was also provided by the Welsh Government to one health board as 'brokerage' – ie, an advance on future funding, which would be reduced accordingly. In agreeing the funding, the Welsh Government emphasised that it intended to put NHS finances on a more sustainable footing and break the cycle of additional funding at the end of the year. The Welsh Government made clear that it expected NHS bodies to deliver within the revised budgets. But by the end of the financial year, three health boards required further funding of £12.4 million. The Welsh Government agreed to cover the deficits through 'brokerage', rather than simply provide additional resources, so (as set out above) future funding would be reduced accordingly.

16 In 2011-12, the Welsh Government continued to use its strengthened monitoring to take more timely action to address emerging issues. It intervened earlier in the year to provide the additional funding, thereby giving greater certainty to NHS bodies as to the extent of the total funding to be made available. By providing brokerage at the end of the year, rather than simply giving more money, the Welsh Government has come closer than in the past to backing up its message that no further funding will be available. Also, judicious use of brokerage potentially helps to address the short-term focus imposed by the requirement to break-even each year by allowing NHS bodies to break-even over a longer period, and potentially to take action to invest to save.

There are positive signs for long-term reform to address unprecedented future financial challenges but short-term funding gaps remain a concern

17 The NHS faces unprecedented financial challenges between now and 2014-15. Depending on which forecasts are used, NHS bodies need to manage cost and demand pressures in the order of £870 million to £1 billion between 2010-11 and 2014-15.

18 The NHS faces a particular challenge in 2012-13 and NHS bodies are developing three-year service and financial plans to ensure that the identified financial challenge can be met. It will be important that these plans are robust and deliverable. Going forwards, the NHS needs to sustain the savings it has already made, and increase the level of cash-releasing savings by around £250 million more each year. It is likely that many of the opportunities for making 'quick-wins' in terms of efficiency savings have already been taken up. As a result, future plans will need to focus increasingly on the more difficult areas for recurring savings: reducing costs by reforming and reshaping services.

19 The NHS is well aware of the challenges it faces. While there are positive signs in terms of long-term reform, ambitions set out in the NHS Five Year Framework will be increasingly challenging for the short term. The NHS Five Year Framework (covering 2010-11 to 2014-15) sets out the ambition to 'close the funding gap while simultaneously improving quality and maintaining service levels and jobs'. The ambition in relation to maintaining job levels is particularly challenging with a significant proportion of NHS spending accounted for by pay. In its recent five-year plan for the NHS workforce, the Welsh Government does not repeat the ambition of sustaining job levels. It sets a specific goal of reducing costs and ensuring workforce costs overall are affordable. Effective workforce planning, linked to changes in the way services are provided, becomes increasingly important, to manage the potential impact of changes to staffing levels on service levels and provision. The challenge for the NHS is that the reshaping of services is likely to take time to deliver, and the imperative for savings is more immediate, driven partly by annual financial targets.

20 The focus on meeting annual financial targets could encourage short-term thinking and actions, such as cutting or deferring expenditure at the end of the year to balance the books. In 2011-12, the NHS bodies needed to deliver around 40 per cent of their planned savings in just three months. There would be merit in exploring options, within current accounting rules, to develop a more flexible approach to encourage a focus on savings, reform and break-even over a longer period than one year. The Welsh Government has recognised the need to support service change and measure improvement over a longer period than one year. It has committed to a review of the financial regime, which it intends will be wide-ranging and lead to improvements across the financial system in the NHS.

21 There are clear signs of progress with longer-term reform of NHS services, so that they deliver high-quality services within the available resources. The Welsh Government has set a clear expectation that radical reform is needed. *Together for Health: A Five Year Vision for the NHS in Wales* reaffirms some of the key elements of reform that have previously been set out in Welsh Government visions for the NHS. The key difference between the current drive for reform and previous efforts is the growing recognition that the status quo is simply unaffordable.

22 The challenge is that there is a catch-22: the status quo is unaffordable but the process of delivering the reform itself carries a cost that may be difficult to fund. There is a 36 per cent cut in real terms in capital funding for the NHS across the current spending period. Capital is likely to be required to fund any infrastructure required to deliver the new, reformed ways of working. Other parts of the public service, like local government, can partly accommodate capital cuts by borrowing, but this is not an option for NHS bodies. In recent times, there has been a moratorium on Private Finance Initiatives in the NHS in Wales. There is, therefore, a major challenge for the NHS and Welsh Government to identify the costs of reform and the options to fund it.

Recommendations

R1	Despite reporting significant savings, NHS bodies required additional funding in recent years. In particular, there are challenges in achieving cash-releasing workforce savings. In order to help address the short-term funding gaps, **the Welsh Government should**: • **further support NHS bodies in sharing good practice on making cost reductions, particularly efficiency savings that do not impact on quality or service levels; and** • **provide challenge to NHS bodies as they develop their three-year plans to ensure they accelerate the cash-releasing savings from workforce planning while managing the risks to service levels and quality.**
R2	The longer-term sustainability of health services depends on radical reform of the way services are delivered and organised. The NHS faces a major challenge in funding that reform especially as there are large cuts to capital funding. **The Welsh Government should work with NHS bodies to identify the capital costs of reforming services, ensure these are properly prioritised within available resources and explore alternative options for funding or providing the necessary infrastructure that supports the reform of NHS services.**
R3	In recent years, the proportion of NHS bodies' funding that has been allocated during the financial year, instead of at the outset, has risen substantially. Whilst there are valid reasons for this, **the Welsh Government should ensure that NHS bodies are provided with as much detail as possible on funding before the start of a financial year to facilitate effective financial planning.**
R4	The Welsh Government has improved the monitoring information it gathers on NHS bodies' financial positions throughout the year. This improved information has helped the Welsh Government to take more timely decisions on funding pressures in the year. There are, however, some areas where the monitoring system could be strengthened further to provide a more accurate picture of the likely end-of-year position. **The Welsh Government should work with NHS bodies to:** • **ensure that the information on expected end-of-year out-turn is consistent across NHS bodies, in particular that they strike a similar balance between optimism regarding break-even and a realistic assessment of the challenge; and** • **ensure that, where possible, NHS bodies profile expected savings from central budgets and accountancy gains across the year in their monitoring returns to give a more realistic picture in-year.**
R5	There are several different official assessments of the cost pressures that the NHS faces between now and 2014-15, with differences between them. **To support better financial planning, and clarify the scale of the challenge the NHS faces and the savings that are required, the Welsh Government should:** • **update the assessment of the cost pressures on the NHS, which are currently set out in the Five Year Framework; and** • **consider this updated assessment against other measures of cost pressures from elsewhere in the UK public sector.**
R6	The resource accounting regime of the NHS has a short-term focus on breaking even within each financial year. This potentially makes it difficult for NHS bodies to create funds to invest in transformation and change in order to deliver savings in future years. **Within the current framework of resource accounting, the Welsh Government should assess the current requirement for health boards to break-even each and every year, and develop options that would enable NHS bodies to invest in new ways of working where these are likely to deliver savings in the future and enable them to break-even over a longer period.**

Part 1 – In the past, despite rising budgets, improved financial monitoring and a greater focus on cost savings, NHS bodies have required additional year-end funding to break-even

1.1 This part of the report examines in detail the funding for health in recent years, up to 2010-11. It sets out the pattern of health funding and spending. It assesses the factors that contribute to the cost and demand pressures that the NHS has faced. It also sets out developments in the Welsh Government's oversight and monitoring of the financial performance of NHS bodies.

1.2 During the period covered in this part of the report, the NHS in Wales has gone through significant structural change. On 1 October 2009, the system involving 22 local health boards commissioning services from nine NHS trusts came to an end. In its place, seven health boards are now responsible for planning and delivering healthcare services in seven regions. Two of the NHS trusts remain and are responsible for providing specialist services: the Welsh Ambulance Services NHS Trust and Velindre NHS Trust which provides specialist cancer services. There is also a new Public Health Wales NHS Trust. The Welsh Government intended that one of the benefits of these changes would be to help to rectify some of the historic problems of financial planning and management in the NHS.

1.3 This report covers the period from 2006-07. During that period, the NHS bodies have worked within two sets of accounting rules, depending on whether they are a trust or a health board. One of the key financial requirements for health boards is the statutory requirement to break-even each and every year. For NHS trusts, the requirement is to break-even, taking one year with another (see Paragraph 4).

Health budgets have risen each year between 2006-07 and 2010-11

Over the past five years, the health budget has increased above inflation every year although recent rises have been steeper in some other parts of the UK

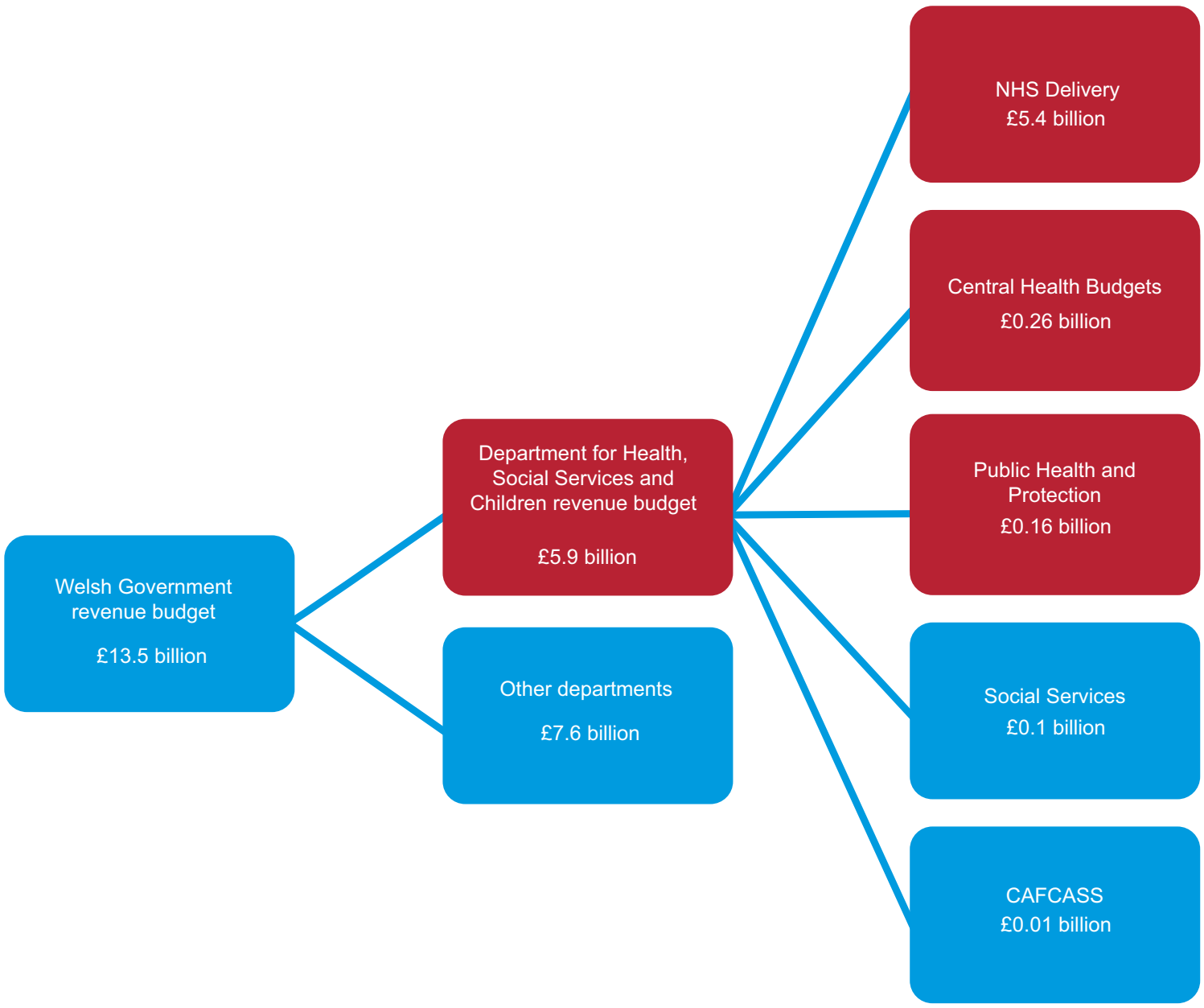
1.4 It is important to clearly set out which set of figures we are using for our analysis in this report. Each year, the Welsh Government sets a budget. The budget is split into what are known as 'Main Expenditure Groups' (MEGs). The MEGs reflect the structure of the Welsh Government, with each MEG representing a department. Health is part of a wider Department for Health, Social Services and Children (the Department). Therefore in focusing on health finances, we have excluded the non-health elements of the budget. Figure 1 sets out the structure of the Welsh Government's budget for health in the 2011-12 Final Budget[1]. All of the elements coloured in red in Figure 1 make up the 'health revenue budget'. This term covers all of the budgeted revenue allocated to spending on health. However, it should be noted that whilst the majority of this budget is provided to NHS bodies, there is an element that goes to non-NHS bodies, such as the Food Standards Agency, and for academic research and development. For Part 1 of this report, which examines historic funding, we focus on the overall health revenue budget. The three sub-categories of NHS Delivery; Public Health and Prevention; and Central Health Budgets were introduced in June 2010, which means

1 Although it is called the 'Final Budget' it is not usually the final version of the budget. The 'Final Budget' is the budget that is agreed by the National Assembly before the start of the financial year. During the year, the budget is updated through 'supplementary budgets'.

we cannot compare the lower-level categories over time. In Parts 2 and 3, we use the NHS Delivery line to examine cost pressures facing frontline health services.

1.5 Figure 1 shows how the Welsh Government apportions the health revenue budget between the various categories. However, the Welsh Government's budget does not set out exactly how much of the funding it intends to pass on to the various NHS bodies that deliver health services. Each year, the Welsh Government writes to the NHS bodies, setting out their 'allocations' for the year. Figure 2 shows the health revenue budget between 2006-07 and 2010-11. It shows that the vast bulk of the funding allocated to the health budget is allocated to the various NHS bodies. The amount allocated to each individual NHS body is primarily based on historic funding patterns. The remainder of the budget is allocated to a range of programmes, including public health programmes managed by the Welsh Government, and non-NHS bodies as touched on in Paragraph 1.4.

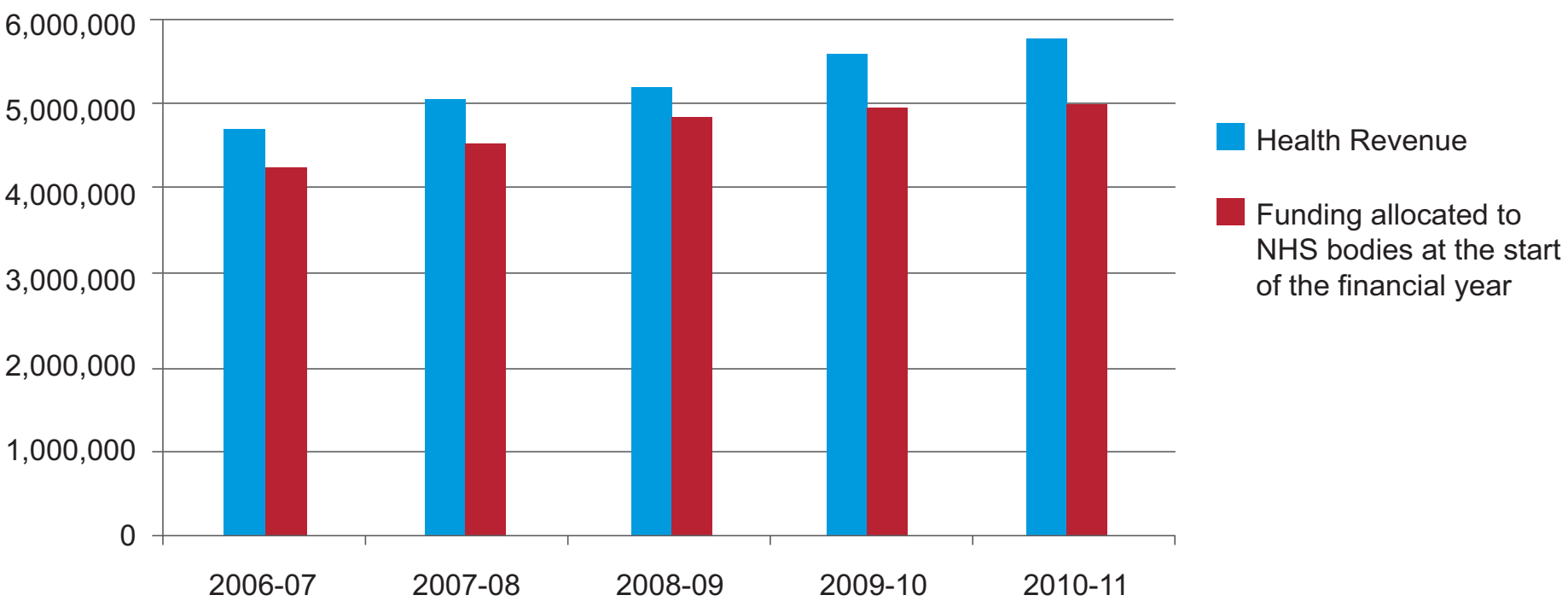
Figure 1 - Breakdown of Welsh Government 2011-12 Final Revenue Budget, focussing on health



Source: Wales Audit Office analysis of Welsh Government budgets

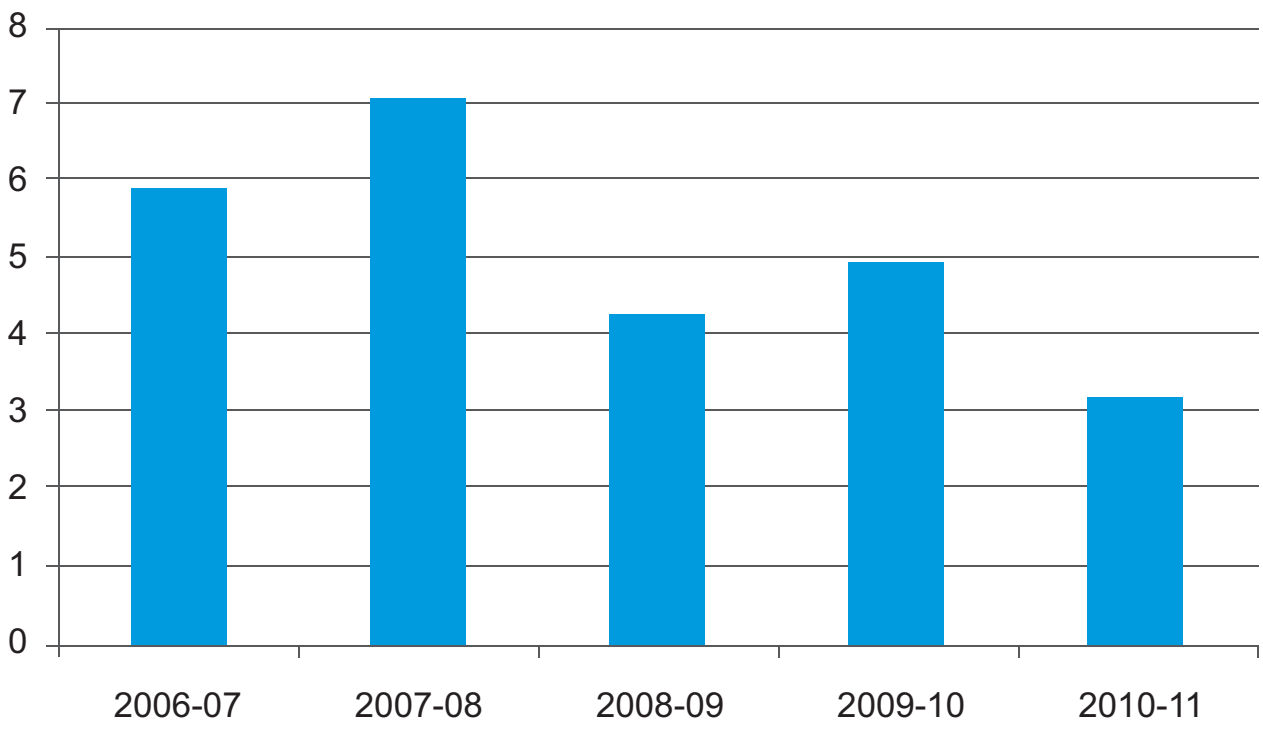
1.6 The health revenue budget has increased every year since devolution. Figure 3 shows that, over the past five years, the rate of increase has varied from around three per cent to as much as seven per cent, in cash terms. The rate of increase was higher in 2006-07 and 2007-08 than in later years. The health budget has seen significant increases, even after taking account of economy-wide inflation[2]. It is common practice to use the GDP deflators to calculate and report real terms budget changes, which is why we have used the deflators as the basis for Figure 4. However, it is widely accepted that cost and demand pressures in healthcare exceed inflation across the wider economy. Figure 4 shows that the health revenue budget increased ahead of economy-wide inflation in every year over the past five years.

Figure 2 - Health Revenue Budget 2006-07 to 2010-11 and funding allocated to NHS bodies at the start of the financial year



Source: Welsh Government final budgets and NHS bodies' allocation letters

Figure 3 - Cash terms increases in the health revenue budget (%)

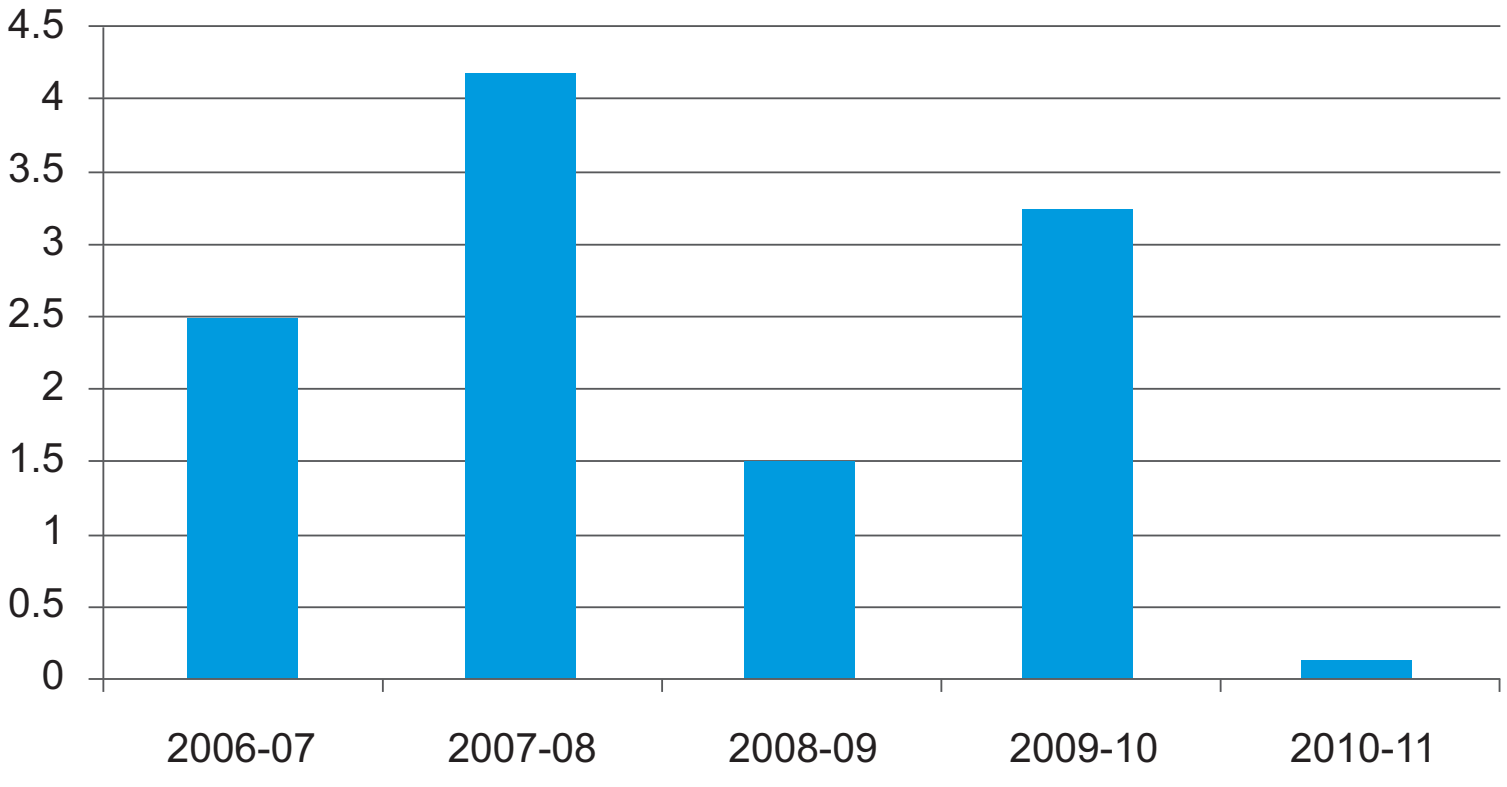


Source: Welsh Government final budgets

2 For this report, we have used the Treasury GDP deflator series issued in December 2011.

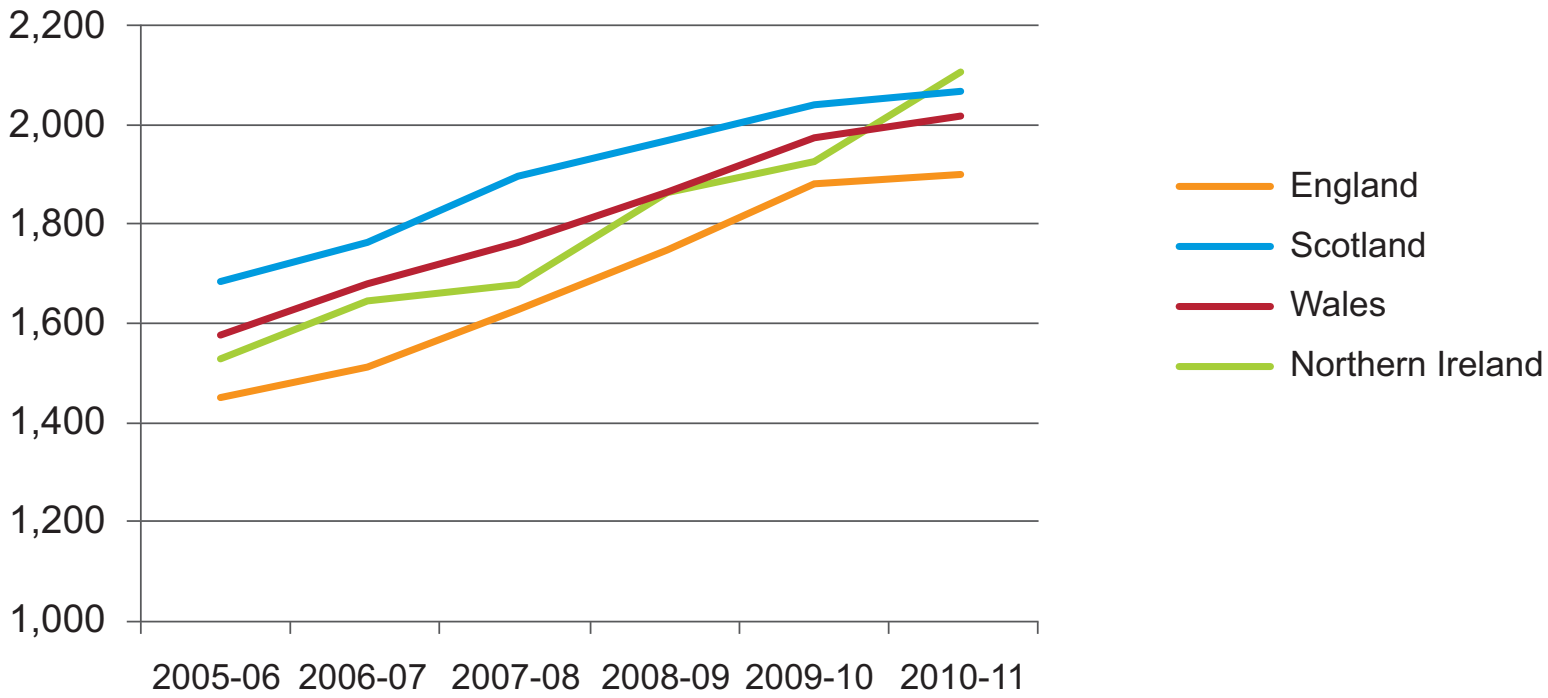
1.7 The pattern of spending rising year on year is mirrored across the UK. Figure 5 shows health spending per head of population in the different parts of the UK. It shows that Wales spent the second highest per head of population, behind Scotland until 2008-09, when it was overtaken by Northern Ireland. Wales remained ahead of England in 2010-11. However, health spending in England increased at a faster rate than in Wales between 2007-08 and 2009-10, although spending in Wales increased ahead of England in 2010-11. It is worth noting that Welsh spend per head is more comparable to English regions with similar demographics, such as North East England. The higher health spend per head in these more deprived areas are offset by much lower spends per head in areas such as South East England, lowering the overall spend per head for England shown in Figure 5.

Figure 4 - Real terms increase in health revenue budget (%)



Source: Wales Audit Office analysis of Welsh Government budgets

Figure 5 - Spending on health per head of population



Source: HM Treasury Public Expenditure Summary Analysis 2011

In recent years, the Welsh Government has had to draw from Welsh Government central reserves to enable NHS bodies to break-even

1.8 As noted above, there are two main elements to the health budget. There is the overall health revenue budget, which is voted for by the National Assembly, and within this, there is the NHS allocation: the funding allocated to individual NHS bodies. NHS bodies are given an initial funding allocation some months before the start of the financial year, but during the financial year additional funding may be provided to them as follows:

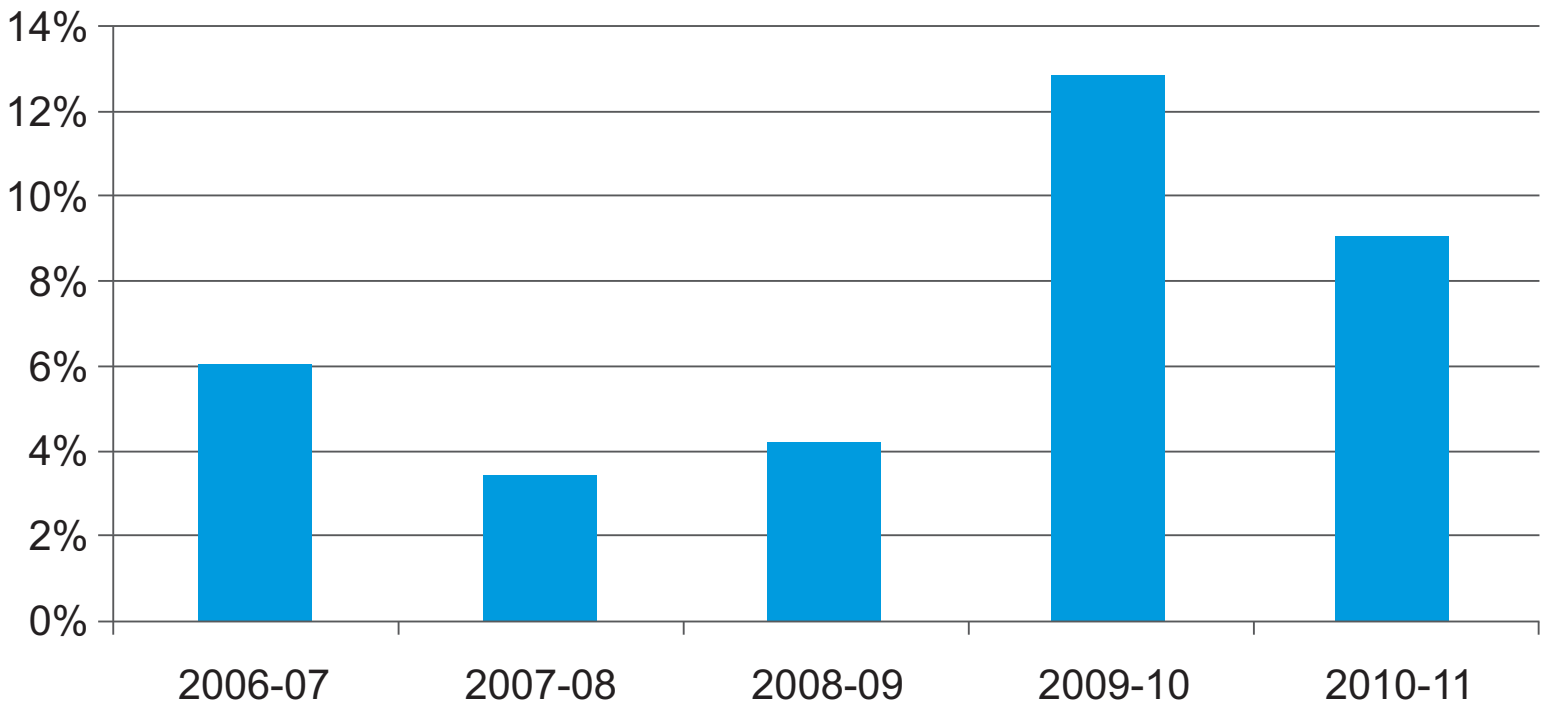
- additional allocation of planned and targeted in-year funding from within the overall health revenue budget, which is moved from central programmes to NHS bodies when finalised;
- funding from within the health revenue budget not initially planned to be distributed to NHS bodies, usually to meet additional pressures; and
- funding from Welsh Government central reserves in addition to the health revenue budget set out in the final budget, again usually to meet additional pressures.

1.9 Figure 6 shows the level of increase from NHS bodies' initial funding allocation to their final funding allocation at the end of the year.

1.10 There are a number of valid reasons for allocating some of this funding to NHS bodies during the year:

- some of the funding is demand-led, for which the Welsh Government assumes the risk and takes responsibility for meeting the costs;
- some of the funding is dependent on negotiations during the year, such as primary care funding where the final costs are known at the end of negotiations between GPs and the UK Government; and
- some funding is allocated to meet specific Welsh Government objectives following submission of plans by NHS bodies.

Figure 6 - Increase from initial allocation to NHS bodies to final allocation (%)



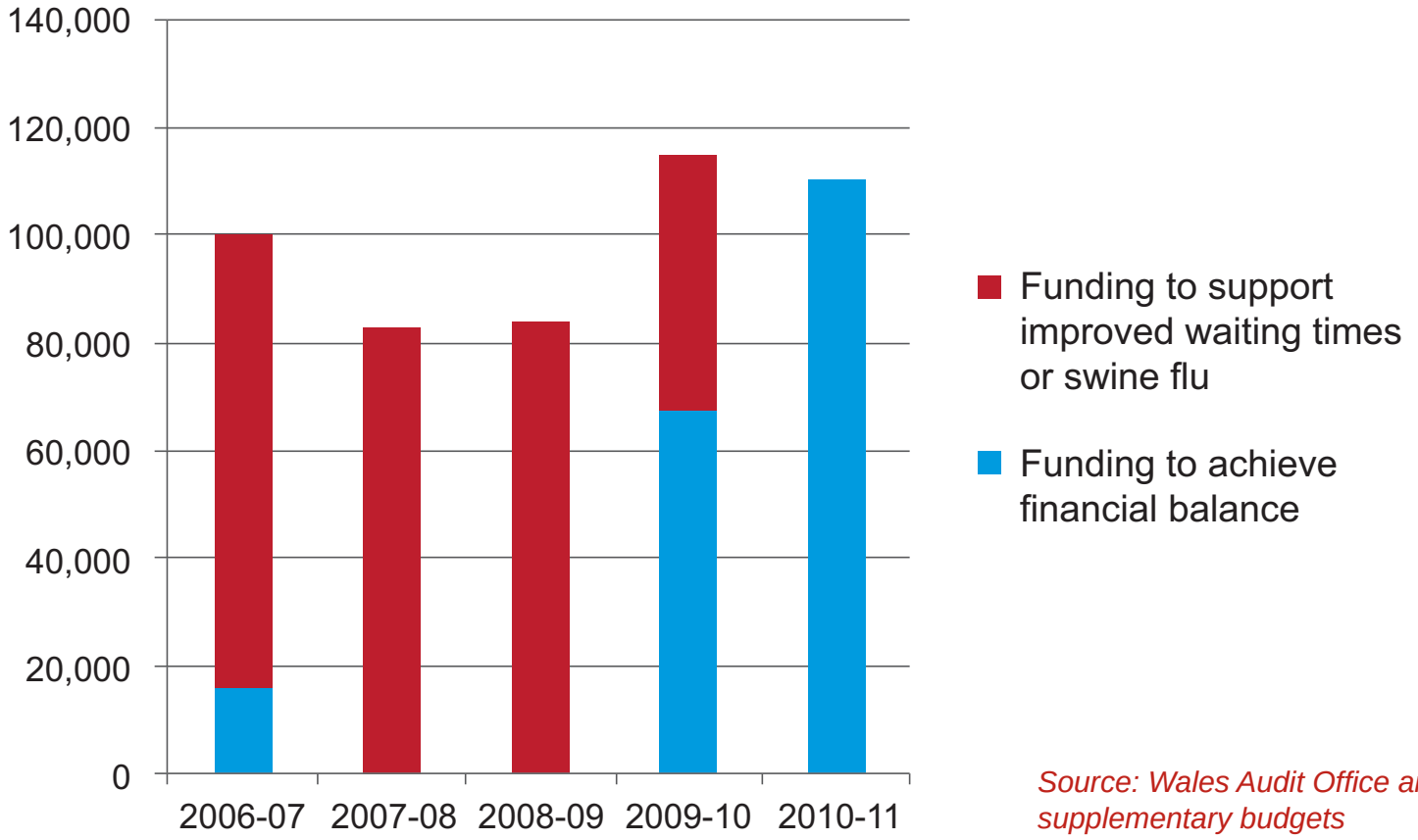
Source: Wales Audit Office analysis of NHS allocations data

1.11 The chart shows a significant increase in the proportion of funding provided within the year in 2009-10 and 2010-11 as compared with earlier years. In 2009-10, the change in organisational structure of the NHS meant that the allocation of significant funding to NHS trusts would now be made via the health boards rather than directly from the Welsh Government. For example, in 2009-10, 4.6 per cent of the overall 13 per cent increase related to non-recurrent depreciation and impairment charges that would have been funded directly to NHS trusts in previous years. Whilst the allocation of funding to NHS bodies during the year is a practical response to the changing NHS environment, it remains essential that NHS bodies are provided with as much detail as possible before the start of a financial year to enable effective financial planning.

1.12 An element of the increases shown in Figure 6, and in addition to the routine funding increases referred to above, is additional funding provided by the Department to NHS bodies from within its own health revenue budget to enable them to break-even.

The final element of the additional in-year funding, shown in Figure 6, is that provided by the Welsh Government to NHS bodies from central reserves. These amounts are shown in Figure 7 and their nature has changed significantly across the years. Much of the additional funding in 2006-07, all of it for 2007-08 and 2008-09, and £21 million in 2009-10 was funding to support improvements in waiting times. Also, £20 million of the additional funding from reserves in 2009-10 was to cover the costs of swine flu and NHS reorganisation. However, in 2009-10 and 2010-11, the Welsh Government needed to provide additional funding from reserves primarily to enable NHS bodies to break-even. In 2010-11, the additional funding to the NHS from reserves accounted for 42 per cent of the Welsh Government's reserves.

Figure 7 - Additional funding provided to NHS bodies from central reserves



Source: Wales Audit Office analysis of Welsh Government supplementary budgets

Overspends are likely to be partly explained by activity to improve access to, and quality of, health services as well as demand and inflationary pressures

1.13 The NHS faces a range of cost pressures that mean that it needs more money each year just to stand still. Pay is a major driver of cost; the overall pay bill at local NHS bodies has risen by 25 per cent or £576 million between 2005-06 and 2010-11. Pay increases account for 17.5 of the 25 percentage point increases, with pay increasing by an average of 3.5 per cent each year over that period. It is important to note that the increase in pay comprises both the headline 'pay rise' as well as what is known as 'pay drift'. Examples of pay drift include staff moving up 'spine points' within their grade, and rises for national insurance, which increases the overall pay bill. The remainder of the increase in pay is due to the number of Whole Time Equivalents (WTEs) increasing from 68,686 to 73,074 over the period – a 6.5 per cent increase (4,388 WTEs).

1.14 Medicines are another key driver of cost. The total NHS body spend on drugs, appliances and clinical supplies in 2005-06 was £855 million. The total cost in 2010-11 had increased to over £1 billion, an 18 per cent increase, averaging a 3.5 per cent increase each year.

1.15 Demand is a driver of costs over the long term. Our report, *A Picture of Public Services*, identified the demographic factors, particularly age-related spending, that push up demand on the NHS over time. The Kings Fund and Institute of Fiscal Studies[3] have estimated that rising demand accounts for around 1.1 per cent real terms increase in cost each year. There are also lifestyle factors, such as alcohol and obesity, which place increasing demands on health services.

1.16 The push for improvement in access and quality of care also contributes to the cost increases within the NHS. Plans, including targets, to lower waiting times, reduce healthcare-acquired infections and improve quality of care sometimes require additional activity and cost. Over the past decade, there have been longstanding commitments to increase funding to the NHS in order to support and enable these improvements. The Kings Fund produced an analysis of what it called the 'productivity gap' in the NHS in England[4]. It concluded that more than half of the 'productivity gap' facing the NHS in England is due to planned improvements in access and service quality. While these costs are not directly reported in budgets and accounts, they are reflected in rising levels of staff – and staff costs – to deliver the activity to meet the access and quality improvements.

1.17 There are some differences as to the precise methods to measure cost pressures faced by the NHS. In late 2009, the National Finance Agreement which drew on data and work provided by the NHS bodies to the Welsh Government, forecast cost pressures in 2010-11 of some 7.2 per cent. However, in June 2010, the Welsh Government published its Five Year Framework, which set out both the inflationary pressures and demographic and demand growth assumptions that it assessed the health service in Wales faced from 2010-11 to 2014-15. The Five Year Framework assessed the inflationary and activity pressures for 2010-11 as being from 3.7 per cent to 4.4 per cent. Whilst these two methods use different approaches for financial planning purposes, it would be beneficial for a common method and set of assumptions to be developed and used.

3 Kings Fund and Institute for Fiscal Studies, *How cold will it be? Prospects for NHS funding 2011-17*, 2009

4 Kings Fund, *Improving NHS productivity: More of the same not more with the same*, 2010

Following reorganisation, the Welsh Government strengthened financial monitoring of NHS bodies and increased the focus on cost control but sent mixed signals regarding the availability of additional funding

Following the 2009-10 restructuring, the Welsh Government strengthened its monitoring of NHS bodies' financial performance and set tough financial targets for 2010-11 which ensured a greater focus on cost control although additional funding was still required

1.18 Following the 2009-10 restructuring, the Welsh Government has monitored the financial performance of NHS bodies more closely. One of the intended benefits of the reorganisation, which has resulted in fewer bodies and less scope for confusion over who is accountable for funding, was to help to facilitate improved financial management. In 2010, the Welsh Government introduced more detail to the monthly monitoring procedure, which requires NHS bodies to submit detailed returns to the Welsh Government within two weeks of each month-end. These monitoring forms require the NHS bodies to provide timely and consistent information on their financial position. They also require NHS bodies to report on overspends as they occur and to forecast the likely end-of-year position in light of progress to date. The Welsh Government also introduced regular meetings between the Department's Director of Finance and the directors of finance in NHS bodies to discuss progress against financial targets.

1.19 Alongside the strengthening of monitoring arrangements, the Welsh Government set NHS bodies very tough financial targets at the start of the year. While the health revenue budget increased by around three per cent, the funding allocated to NHS bodies increased by just 0.7 per cent. The Welsh Government made clear that it expected NHS bodies to manage within this small, below-inflation uplift. This approach reflects the Welsh Government's intention to press NHS bodies to deliver significant cost reductions while also retaining flexibility to provide additional funding from within the health revenue budget should it be required. Given the small uplift in funding allocated to NHS bodies, they collectively set themselves the target of making £413 million savings, and subsequently reported delivering £314 million savings. These reported savings potentially represent a significant achievement by the NHS. It is, however, likely that some of those reported savings were not cash-releasing and therefore did not directly contribute to bridging the funding gap in that year (see Figure 8). The net result was that the NHS bodies required considerable additional funding in 2010-11. The Department was unable to manage this need within the health revenue budget and had to provide an additional £110 million from Welsh Government reserves.

Figure 8 - Reconciling reported savings in 2010-11 to the budget and cost pressuresion

Paragraph 1.17 reported the complexity in accurately assessing the cost pressures facing health budgets in 2010-11. Taking account of those different approaches, and the underlying deficit from 2009-10, we calculate that there was a funding gap of between £126 million[5] and £281 million[6] across the health revenue budget. These figures suggest there would have been a surplus, had all of the savings been cash-releasing and used to bridge the funding gap. However, as Figure 7 shows, the Welsh Government had to provide an additional £110 million to the NHS from its reserves.

In part, the difficulty reconciling the reported savings to the budget and cost pressure forecasts could be explained by the different types of savings that NHS bodies make. Not all savings are cash-releasing. It is possible that a significant proportion of the reported savings were reinvested in improvement activity, and therefore did not contribute directly towards bridging the funding gap. It is also likely that some of the savings represented 'cost avoidance', for example containing cost rises in particular goods or services to below inflationary cost pressures set out in the Five Year Framework and the National Finance Agreement. The NHS is also supporting strategic service change through the reinvestment of some cash-releasing savings into new models and settings of care.

1.20 The improved financial monitoring meant that the Welsh Government was aware of the need for additional funding earlier than in previous years. It recognised that further funding would be required and made the additional funding available to the NHS bodies in December 2010, rather than waiting to the end of the financial year.

The Welsh Government recognises that the provision of additional funding poses some challenges in terms of developing a culture of cost control

1.21 One of the major challenges in a service that is demand-led with increasing pressures is to establish a culture of cost control. The Welsh Government has set out a clear requirement for NHS bodies to plan and manage within available resources whilst meeting agreed targets. However, the Welsh Government has also provided additional funding during the financial year that has supported NHS bodies to meet those targets and break-even. Where NHS bodies overspend, the Welsh Government is under pressure to cover those deficits: in part, because accounting rules mean that its own accounts could be qualified as a result of overspends at one or more NHS body. Having its accounts qualified would be uncharted territory for the Welsh Government, and while the precise consequences are uncertain, it would be likely to cause significant reputational harm to the Welsh Government.

1.22 There are concerns that the focus on breaking even at the end of the financial year encourages an excessively short-term focus. At a meeting of the Public Accounts Committee of the National Assembly, the Chief Executive of Aneurin Bevan Health Board described the challenge of delivering a break-even on the £6 billion health budget as akin to 'landing a jumbo jet on a postage stamp'.

5 This figure is based on the gap between the actual 3.2 rise in the heath revenue budget and the 4.4 per cent cost pressures identified in the Five Year Framework, plus £60 million underlying deficit from 2009-10.

6 This figure is based on the gap between the actual 3.2 rise in the heath revenue budget and the 7.2 per cent cost pressures identified in the National Finance Agreement, plus £60 million underlying deficit from 2009-10.

1.23 Over the years, an apparent pattern has emerged where the Welsh Government tells NHS bodies that no further funding will be made available but then provides support that covers deficits. There is a risk that this pattern makes it more difficult for finance managers to emphasise the need for cost control to clinicians and operational staff, who may assume that funding for budget overspends will be found from elsewhere.

1.24 There is a risk that the approach to funding at the start of 2010-11 may have exacerbated the perceptions of a hidden pot for funding overspends. Withholding a relatively large amount of funding, setting ambitious targets and sending out a tough message that no further funding would be available was risky. Holding a contingency to manage unexpected events is sensible, but needs to be carefully communicated to avoid NHS bodies and staff making their own assumptions about the size of such a contingency fund. And there are also risks associated with a tough 'no further funding' message when it is clear to many within the NHS that some contingency was available. The tough message was undermined when additional money was subsequently made available. The combination of factors may have contributed to perceptions that there is a hidden pool of money to fund deficits. Parts 2 and 3 show that the Welsh Government has learnt lessons and is moving towards greater transparency over funding and backing up its messages on not providing further funding at the end of the year.

Part 2 – In 2011-12 NHS bodies again reported significant savings, and the Welsh Government has sought to put health finances on a more sustainable footing that helps break the cycle of additional year-end funding

2.1 This part of the report examines the scale of the NHS funding gap in 2011-12, and the action taken by the Welsh Government and the NHS bodies to close that gap by the end of the financial year. It examines:

- the scale of the funding gap at the start of the year;
- the reported savings that NHS bodies made and progress in staying within budget across the year;
- the additional funding required to enable the break-even position; and
- the oversight and monitoring of progress by the Welsh Government.

In 2011-12, there was an in-year funding gap in the order of £280 million to £380 million at the start of the financial year

2.2 As set out in Part 1, the NHS faces a range of cost pressures and precisely identifying the scale of the 'funding gap' – the difference between the funding allocated to NHS bodies and the estimated cost and demand pressures – is complex. There are three different versions of the funding gap, based on:

- cost and demand forecasts from the NHS Five Year Framework;
- forecasts from the National Finance Agreement, based on health boards' own assessments; and
- NHS bodies' own collective assessment of the funding gap.

2.3 Figure 9 shows the funding gap based on the NHS Five Year Framework and the National Finance Agreement. We have used the NHS Delivery line from the budget (see Appendix 1 for an explanation). The NHS Five Year Framework estimates cost and demand pressures amounting to around 3.3 per cent in the year. Using these estimates, there was a funding gap in the order of £280 million. While this may seem low, it reflects the fact that there has been a wage freeze across the NHS. The National Finance Agreement estimates cost pressures of 5.2 per cent.

2.4 At the start of the year, the NHS bodies themselves identified an in-year gap of £279 million. NHS bodies also had an underlying deficit[7] from 2010-11 of £187 million. In order to bridge the in-year gap and eradicate the underlying deficit, NHS bodies identified a total funding gap of £466 million. Collectively, NHS bodies had plans to find £267 million savings to partly bridge the funding gap.

7 The underlying deficit is calculated each year by taking account of non-recurrent income, expenditure and non-recurrent savings.

Figure 9 - Funding gap in 2011-12

Revenue (millions)	2010-11	2011-12
NHS Delivery budget	£5.47 billion	£5.37 billion
Cost pressures in NHS Five Year Framework		3.3%
Cost pressures in National Finance Agreement		5.2%
Funding gap using Five Year Framework		£279 million
Funding gap using National Finance Agreement		£383 million

Source: Wales Audit Office analysis of Welsh Government budgets and cost pressure estimates
Note: To show the gap at the start of the financial year, the figure for 2010-11 includes additional funding allocated in two supplementary budgets (totalling £5.506 billion less non-cash funding). The figure for 2011-12 reflects the budget at the start of the financial year, as set out in the Final Budget 2011-12 approved in December 2011, and does not include the additional funding allocated in the year.

NHS bodies reported savings of £285 million in 2011-12 but received additional funding of £157.4 million from the Welsh Government to address cost pressures and achieve break-even

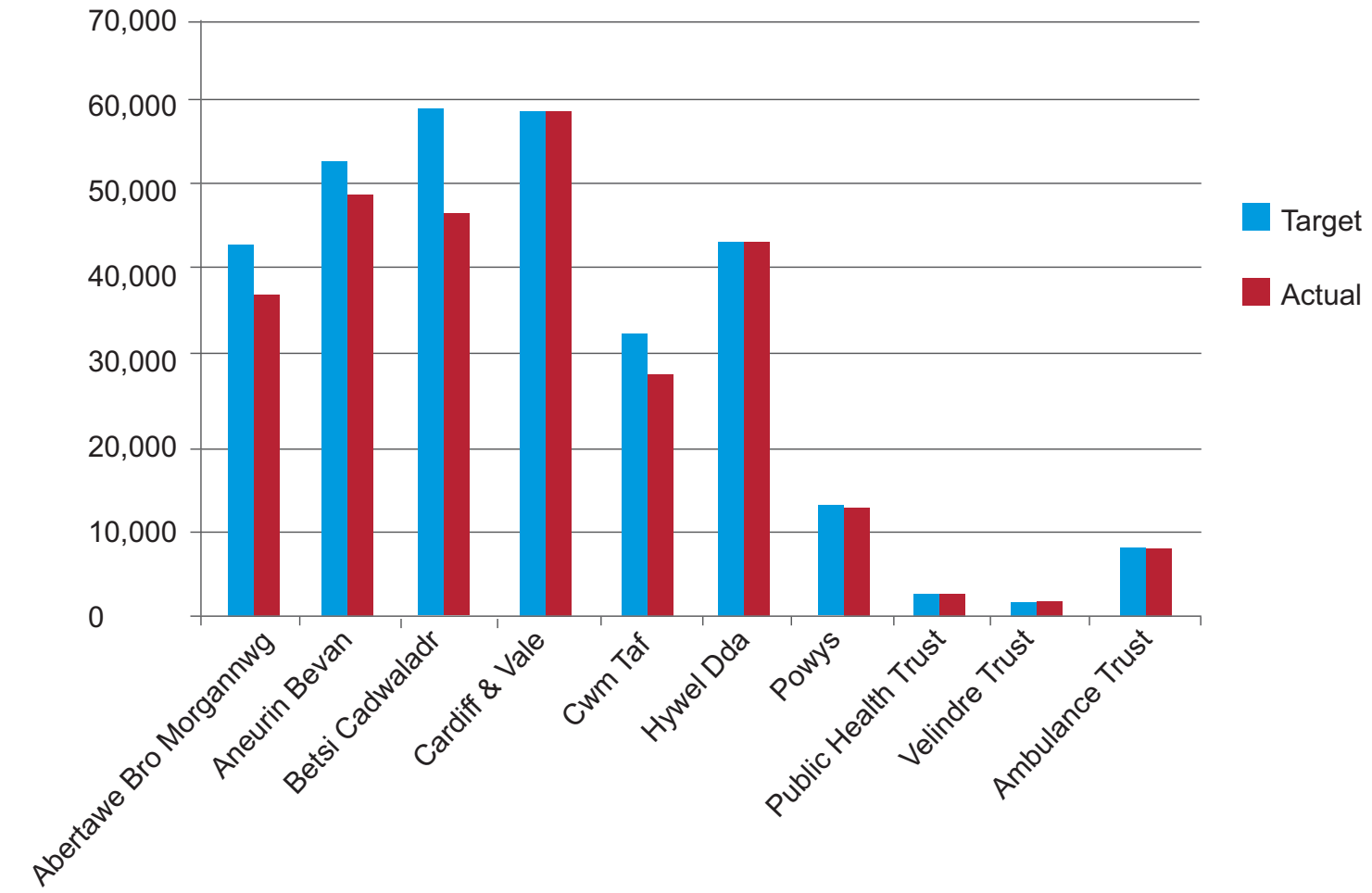
NHS bodies reported savings of £285 million in 2011-12, marginally behind the final target and including significantly more one-off savings than originally planned

2.5 Across the year, the NHS bodies increased the level of potential savings identified from £267 million (Paragraph 2.4) to £312 million. At the end of March 2012, NHS bodies reported having made £285 million savings. This figure is lower than the £314 million savings reported for 2010-11, but is still a significant achievement. However, it is not clear if this represents a substantive reduction in the level of cost savings or more rigorous reporting and classification of the savings. Figure 10 sets out the level of reported savings against targets.

2.6 Figure 11 shows the categories of reported savings. Workforce cost is by some margin the largest area of saving, with £85 million of reported savings through workforce modernisation and a further £7 million from reductions in management costs. However, in both categories, NHS bodies did not meet the collective savings targets. Procurement and other non-pay is the next largest area of savings; with the £66 million reported savings exceeding the target of £57 million. The third-largest area of savings is continuing healthcare where, again, the reported £44 million savings exceeded the plan for the year.

2.7 The health boards struggled to meet their targets for savings on medicines management. They intended that this area would deliver the second-highest level of savings but actually only delivered the fourth highest. The monitoring returns show that five out of the seven health boards exceeded their budgets for primary care prescription drugs, with a combined total overspend of £20 million. Health boards overspent on ‘clinical supplies’ in secondary care, which includes medicines supplied in hospitals, by some £36 million.

Figure 10 - NHS bodies' reported savings compared to target savings 2011-12



Source: Wales Audit Office analysis of month 12 monitoring returns

2.8 Figure 11 shows the two core types of savings: recurrent and non-recurrent. Recurrent savings are sustainable savings that should be saved in future years (so represent a permanent cost reduction). Examples of such savings include reducing the unit cost of purchasing an item in a long-term contract, or changing the way a service is organised so that it can be permanently delivered by fewer staff. Non-recurrent savings are one-off cost reductions. Examples include delaying purchasing an item until the new financial year or delaying recruitment to a post that will ultimately need to be filled. It is positive that 87 per cent of savings are reported as being recurrent. However, the level of non-recurrent savings has increased substantially towards the end of the year. In December 2011, NHS bodies forecast that just £23 million of the savings would be non-recurring, compared to the final position of £38 million non-recurrent savings. The areas where non-recurrent savings increased most in the final few months were workforce and procurement.

2.9 Figures 12 and 13 show how the savings were accumulated over the year and the split between recurrent and non-recurrent savings. Those health boards which achieved savings more evenly through the year (demonstrated by a straighter line in Figure 12), generally achieved a higher level of recurrent savings, whilst those health boards whose savings were achieved more towards the year-end (demonstrated by a curved line), relied to a greater extent on non-recurrent savings.

The Department required an additional £93 million from central reserves, including £63 million made recurrent to address historic shortfalls and £30 million to support Hywel Dda

2.10 The Welsh Government recognised earlier in the financial year that the NHS bodies were unlikely to meet their financial targets and break-even. All of the health boards, bar one, were forecasting a significant end-of-year deficit. The Cabinet of the Welsh Government considered the position in July 2011, based on 2011-12 financial plans and May 2011 monitoring reports, and agreed to place the

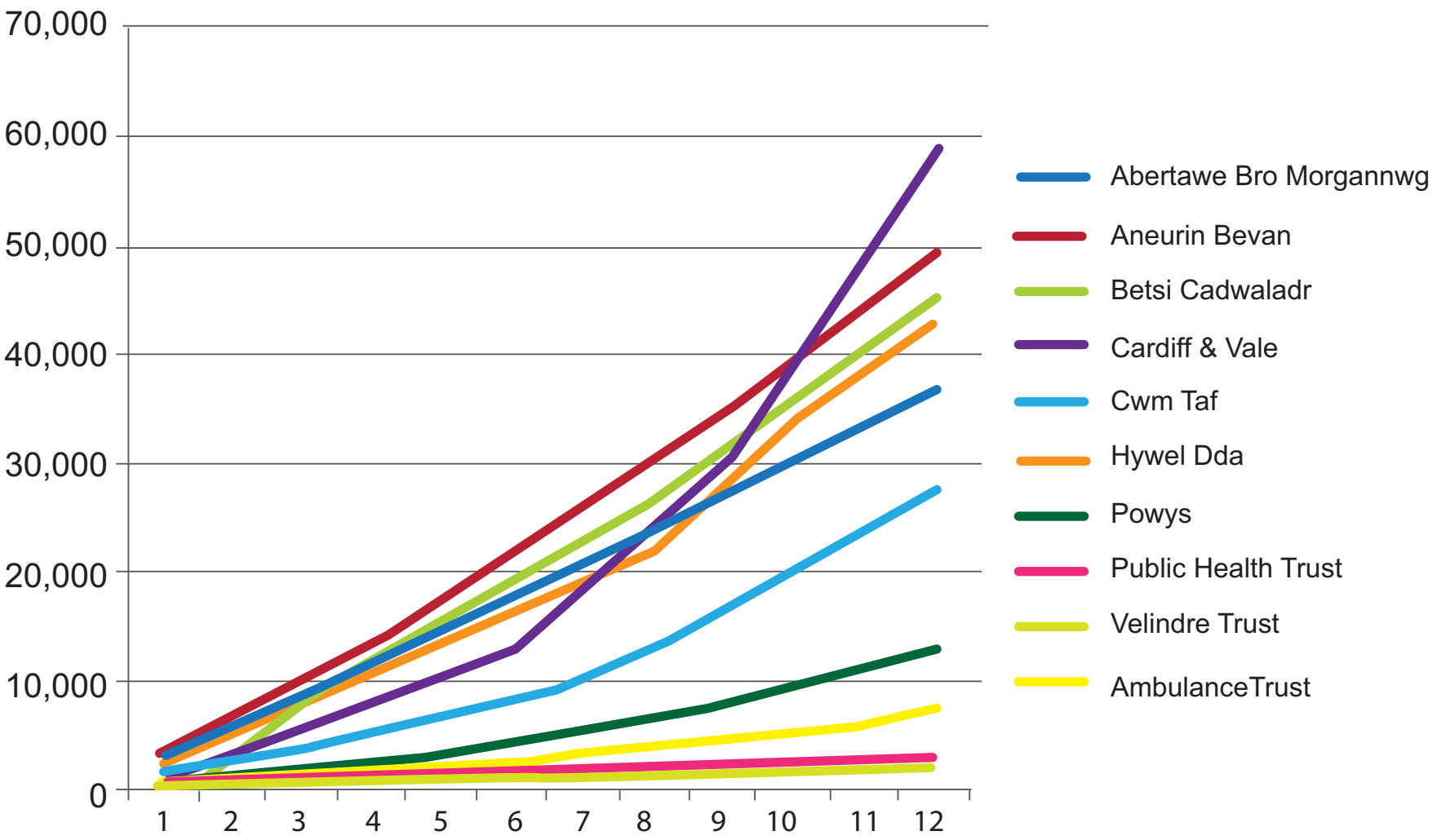
Figure 11 - Categories of reported savings in 2011-12

Savings Catagories	Full-year plan		Full-year actual		Comprising...	
	£000's	%age	£000's	%age	Recurrent £000's	Non-recurrent £000's
Workforce Modenisation	111,392	35.7%	84,551	29.7%	74,609	9,942
Medicines Management (Primary & Secondary Care)	51,330	16.5%	42,710	15.0%	40,331	2,379
Procurement & Other Non Pay (excl Energy)	56,882	18.2%	65,991	23.1%	45,002	20,989
CHC (excl DTOC)	36,094	11.6%	44,447	15.6%	43,600	847
Externally Commissioned Services	32,726	10.5%	28,548	10.0%	25,971	2,578
Management Cost Reductions	9,078	2.9%	7,844	2.8%	7,009	835
Estates / Energy	5,899	1.9%	4,460	1.6%	4,433	27
Specialist Services	6,808	2.2%	4,946	1.7%	4,929	16
Shared Services	1,584	0.5%	1,620	0.6%	1,585	35
Total	311,792	100%	285,117	100%	247,468	37,648
					86.8%	13.2%

Source: Month 12 monitoring returns

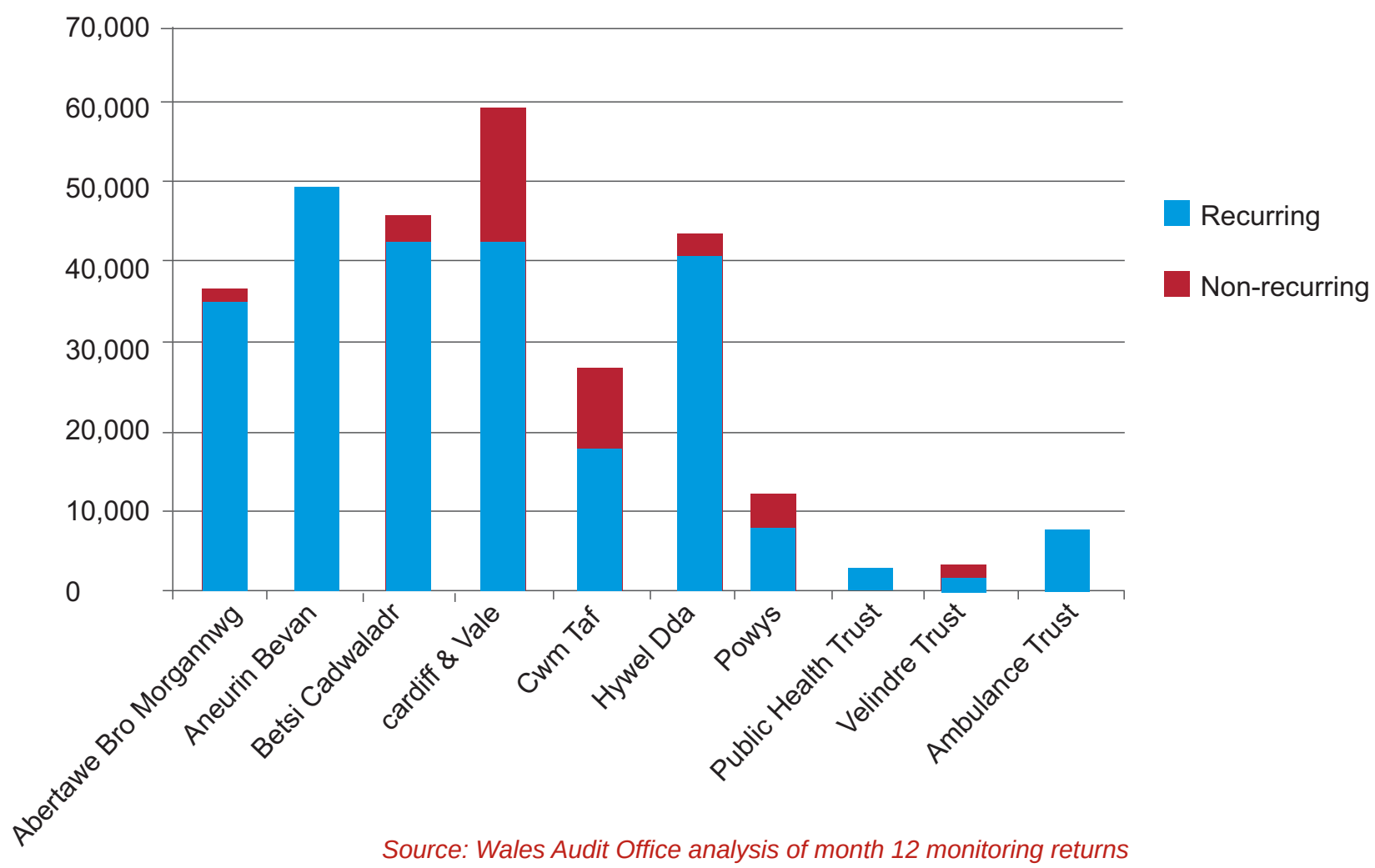
NHS on a more sustainable footing; a situation which had previously been resolved on an ad hoc basis each year with additional funding later in the year. It was therefore agreed to provide NHS bodies with an additional £133 million (£93 million from central reserves, £40 million from within the Department's budget). The Cabinet agreed that £63 million of the additional funding would be recurring, and would be included in the Department's future years' budgets. In addition to this funding, the Department agreed to provide 'brokerage' of £12 million to Cardiff and Vale University Health Board. This is a 'draw forward' of funding from 2012-13 and 2013-14; funding for those years will be reduced by £6 million each. The funding was provided primarily to ensure the Health Board met its 2011-12 financial targets, but also to support an Accelerated Improvement Programme (to underpin successful delivery across the three principal domains of performance: quality, finance and access).

Figure 12 - Accumulation of savings through the year



Source: Wales Audit Office analysis of month 12 monitoring returns

Figure 13 - Split of savings between recurrent and non-recurrent



Source: Wales Audit Office analysis of month 12 monitoring returns

2.11 The provision of additional funding on a recurrent basis and at an earlier stage in the financial year marks a change to previous years and appears to reflect an aim for greater transparency in the approach to funding the NHS. In communicating its decision, the Welsh Government was careful to emphasise that the funding was to address historical funding issues once and for all. Having provided this funding, the Welsh Government emphasised that it expected health boards to be able to achieve their financial targets.

2.12 However, it became clear that three health boards – Aneurin Bevan, Cwm Taf and Powys – would still not achieve their financial targets and would require further funding. In a marked change from previous years, the Department provided a further £12.4 million as brokerage, ie as a 'draw forward' of funding from future years, to ensure these health boards met their financial targets. Their funding in 2012-13 will be reduced by the same amount.

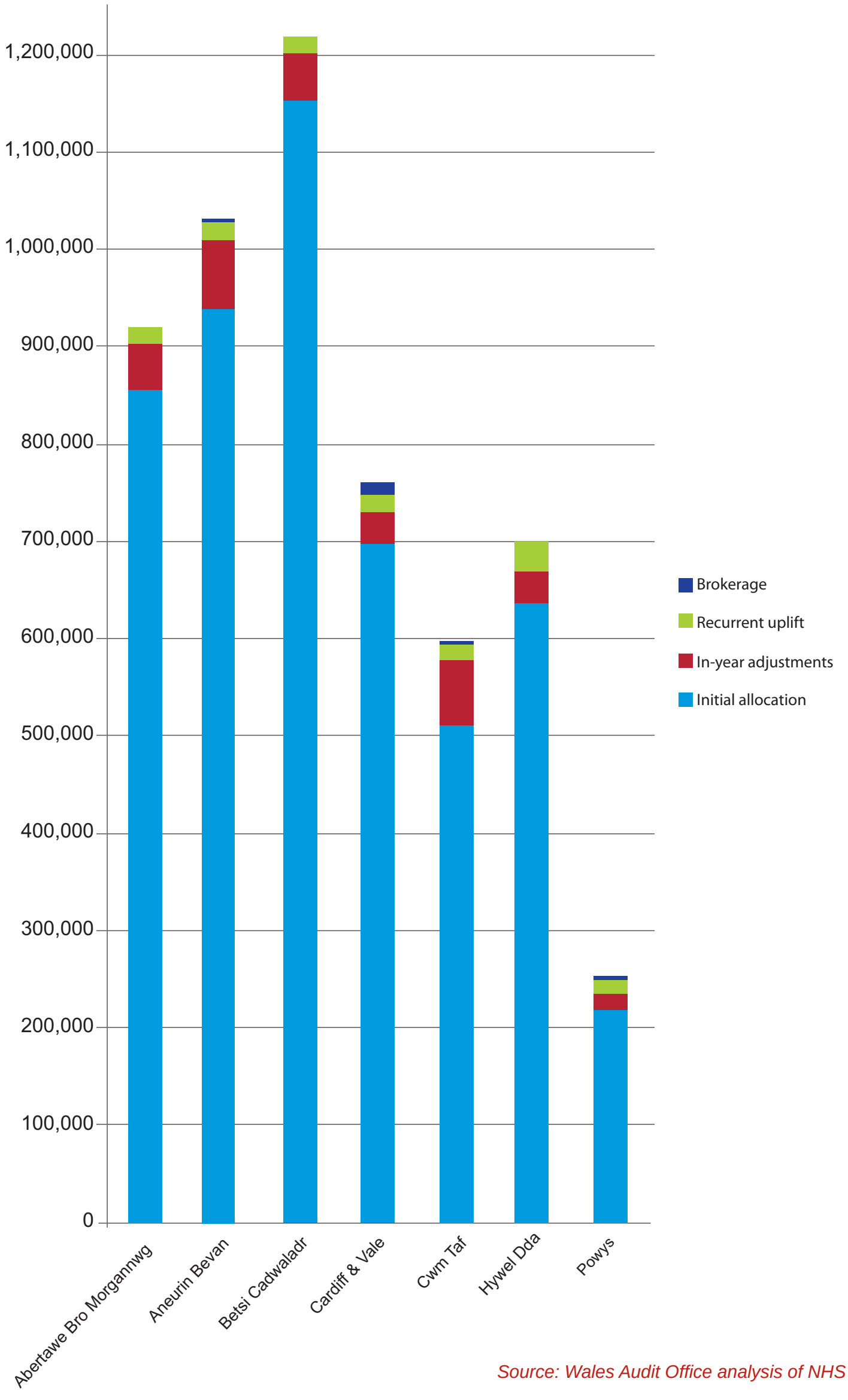
2.13 Figure 14 below sets out this funding split graphically. The additional brokerage provided to Aneurin Bevan, Cardiff and Vale, Cwm Taf and Powys Health Boards was only 0.4 per cent of overall funding in the year.

Comparing cost pressures, savings and additional funding suggests that some of the reported savings may not have been cash-releasing

2.14 Not all savings are actually reductions in cost that free up cash. Sometimes savings create additional capacity that is reinvested in other areas, rather than banked as a hard-cost reduction. Our own work in previous years auditing efficiency gains has shown that it is often very difficult to verify absolutely whether reported savings are efficiency savings or cuts, and whether they are cash-releasing savings or productivity gains.

2.15 We have not sought to verify the £285 million savings that NHS bodies have reported. However, by comparing the estimated funding gaps at the start of the year (Paragraphs 2.3 to 2.4 and Figure 9) and the additional funding provided through the year, it is possible to produce a rough indicator of the potential split between cash-releasing and other types of savings. Figure 15 indicates that cash-releasing savings required in the year accounted for between £309 million and £413 million of the reported savings. It also suggests that, once one-off savings of £38 million (see Figure 11) are excluded, sustainable recurrent savings were between £271 million and £375 million. There remains an underlying deficit of £125 million to address in 2012-13.

Figure 14 - Health board funding allocation 2011-12 in £'000s



Source: Wales Audit Office analysis of NHS allocations data

2.16 Of all the categories of savings, workforce modernisation appears most likely to include non-cash releasing savings. Our experience of auditing efficiency savings in the past suggests that areas such as procurement tend to be clearer in terms of whether goods and services were, or were not, purchased more cheaply. Workforce savings are often more difficult to translate into cash savings; it is often difficult to release cash from improvements that free up a proportion of a staff member's time. Instead, that time is often reinvested in other activity. Monitoring data on workforce costs and levels suggest that savings in this area have indeed been reinvested in other areas. Five of the seven health boards overspent their budget for pay, some quite significantly. Health boards collectively spent £83 million more on pay than planned at the start of the year and the total NHS pay bill for secondary care increased by £48.8 million (two per cent) from 2010-11 to 2011-12. The number of staff employed in the NHS increased, from 78,041 WTEs in 2010-11 to 78,602 in 2011-12, rather than decreased as may be expected in light of the reported savings. An increase in staff is not necessarily a sign of increasing cost, it may be lower cost to take on new staff and reduce the use of expensive agency staff. There has been some overall progress in reducing reliance on agency staff, with variation between NHS bodies, but only one health board (Powys) has met the target of keeping agency spend to 0.8 per cent of the pay bill across the year. Two of the three NHS trusts also met the target.

Figure 15 - Indicative analysis of cash-releasing savings based on cost pressure estimates

	Five Year Framework estimates	National Finance Agreement estimates
Estimated funding gap at the start of the financial year	£279 million	£383 million
Plus underlying deficit brought forward	£187 million	£187 million
Total funding gap	**£466 million**	**£570 million**
Less additional funding provided including brokerage	£157 million	£157 million
Cash-releasing savings required	**£309 million**	**£413 million**
Indicative recurrent cash-releasing savings (cash-releasing less non-recurrent savings in Figure 11)	£271 million	£375 million

Source: Wales Audit Office analysis of NHS allocations data and monitoring returns

The Welsh Government has changed its approach to provide £63 million of this additional funding on a recurrent basis and use brokerage to reinforce a tougher message to NHS bodies

2.17 Detailed monthly monitoring reports are required to be submitted by all NHS bodies by the tenth working day of the following month. The reports require detailed information on the financial position to date and forecasts to year-end for a number of areas including under or overspend against funding allocation and savings plans.

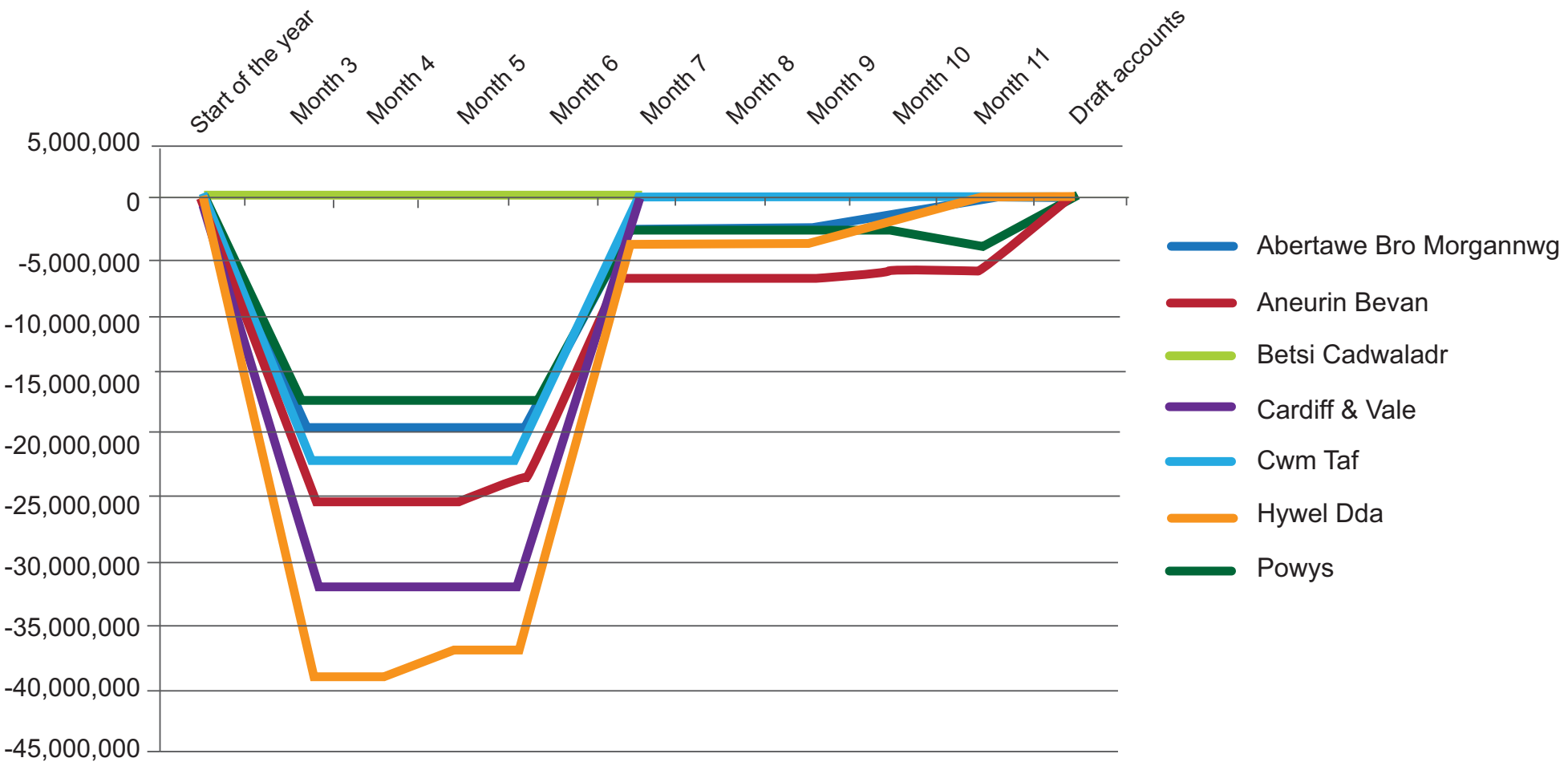
2.18 The forecasting pattern set out in Figure 16, reported through the year by health boards, is consistent with the funding allocation story set out in the section above. Health boards reported a total forecast overspend of £155 million at month 3 with minimal change to this estimate until month 7, when the £133 million funding uplift and £12 million brokerage were provided, reducing the forecast out-turn to £16 million. Further brokerage in month 12 of £12.4 million brought all health boards into a break-even position in their draft financial statements.

2.19 The Welsh Government used the strengthened monitoring return forecasting to assist with their earlier identification of financial problems. At month 6, financial positions were assessed and the funding uplift of £133 million to health boards and the £12 million of brokerage to Cardiff and Vale University Health Board were confirmed in October 2011. All health boards received £17 million with the exception of Hywel Dda and Powys Health Boards who had £33 million and £15 million respectively. The allocation was made taking into account relative sizes of health boards and the scale of financial risk being managed, with particular support to Hywel Dda in line with their four-year package of tapering financial support.

2.20 Also, by providing 'brokerage', rather than simply giving extra money, the Welsh Government stuck to its 'no additional funding' message in a way that it had not in previous years. The use of brokerage, which in effect allows health boards to break-even over a number of years, partly addresses the challenge posed by accounting rules that require break-even each and every year.

2.21 The Welsh Government is carrying out a review of the financial plans of the four health boards that required brokerage at the end of the year. It is also carrying out work at Betsi Cadwaladr and Hywel Dda Health Boards. The Welsh Government intends that these reviews will support health boards in strengthening their financial planning and management. It also intends that the reviews will emphasise the accountability of health boards for managing their finances.

Figure 16 - Health board forecast out-turn through 2011-12



Source: Wales Audit Office analysis of 2011-12 monitoring returns

2.22 Over the year, there have been some difficulties with the Welsh Government's monitoring information. Several of the health boards included large savings from central projects in the final month of the financial year. As a result, the monitoring forms across the year were showing that NHS bodies were likely to deliver a larger deficit than actually occurred. Where possible, those savings should be profiled over the year to facilitate monitoring and planning. Also, the approaches of different health boards may not be entirely consistent, with some striking a cautious note and others including more optimistic forecasts. For example, Betsi Cadwaladr Health Board predicted break-even in every month of the year, despite having an in-year deficit and accessing an additional £17 million in October. Cwm Taf Health Board predicted it would break-even in month 11, but required brokerage at the end of the year.

Part 3 – There are positive signs for long-term reform to address unprecedented future financial challenges but short-term funding gaps remain a concern

3.1 This part of the report examines the financial pressures facing the NHS over the period to the end of the Spending Review (2014-15). In particular, it explores the short-term pressures that the NHS faces to break-even in this financial year (2012-13). It also sets out the financial position to 2014-15, based on the Welsh Government's budget, and sets out the longer-term challenges facing the NHS as it moves into a period of significant reform of service delivery.

The NHS faces real terms cuts until 2014-15 with a significant and growing funding gap

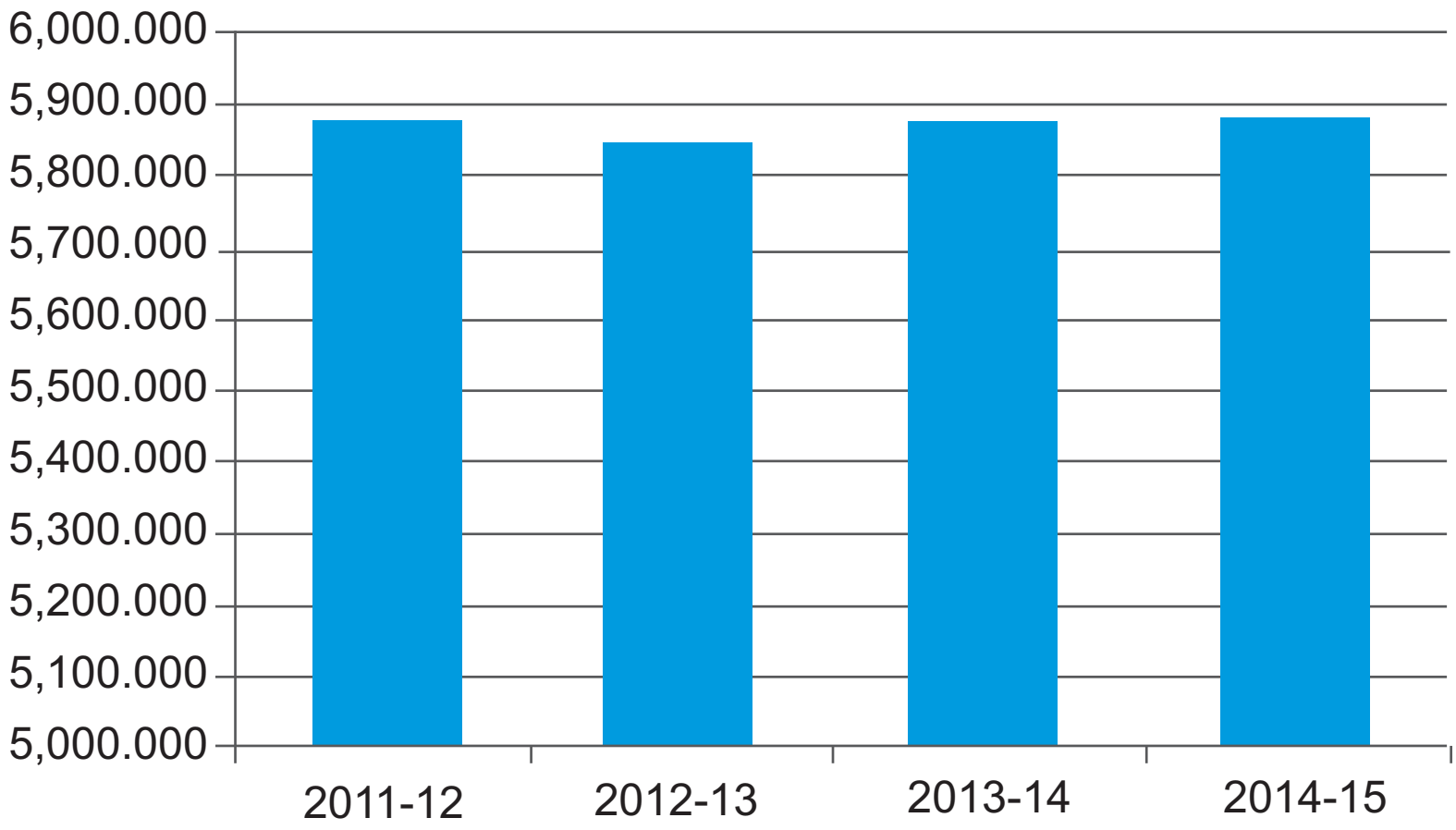
The NHS faces unprecedented financial challenges with real terms cuts to health budgets every year to 2014-15

3.2 Figure 17 sets out the changes to the health revenue budget in cash terms between 2011-12 and 2014-15. These figures include additional recurring funding allocated by the Welsh Government in the December 2011 Final Budget. The Welsh Government agreed additional recurring funding for the health revenue budget in December 2011. In agreeing this funding, the Welsh Government accepted that the NHS should be placed on a more sustainable footing and that previous non-recurrent supplementary budget allocations should be made recurrent. Nonetheless, once inflation is factored in, there is a real terms cut every year in the health revenue budget (Figure 18).

By 2014-15, the revenue budget is likely to be around 10 per cent lower in real terms than 2010-11. As we reported in *A Picture of Public Services 2011,* the NHS in Wales faces the toughest financial settlement over this period of any of the countries in the UK[8].

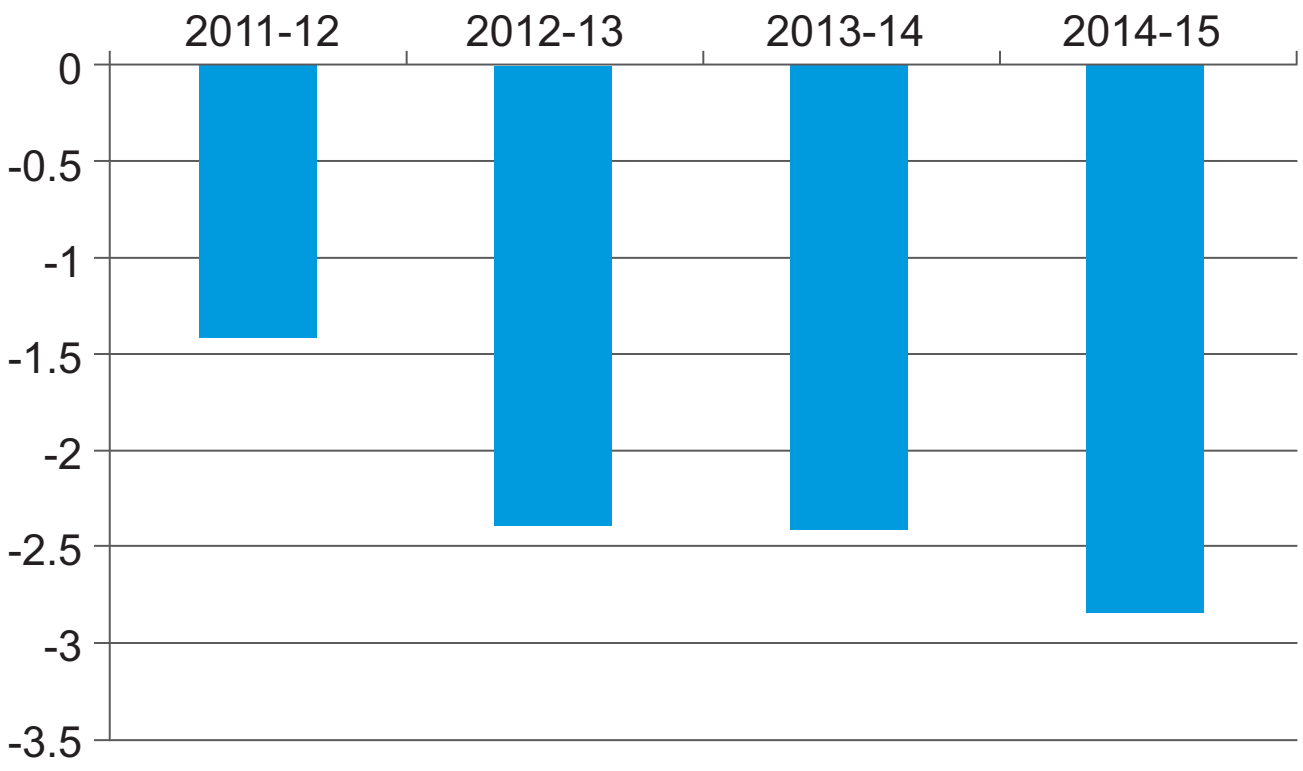
8 Figure 18 differs from the figures used in *A Picture of Public Services 2011*. For consistency within this report, we include all health revenue funding within the Welsh Government's budget. In *A Picture of Public Services*, we used only the 'NHS Delivery' line in the budget. Also, Figure 18 takes account of the impact of supplementary budgets and we have used a more recent set of GDP deflators to calculate the impact of inflation in setting out the real terms budgets.

Figure 17 - Health revenue budgets (£)



Source: Wales Audit Office analysis of Welsh Government budgets
Note: The figure for 2011-12 is based on the Final Budget 2011-12, published in February 2011, plus further funding set out in supplementary budgets. The figures for 2012-13 to 2014-15 are based on the figures in the Final Budget 2012-13 published in December 2011.

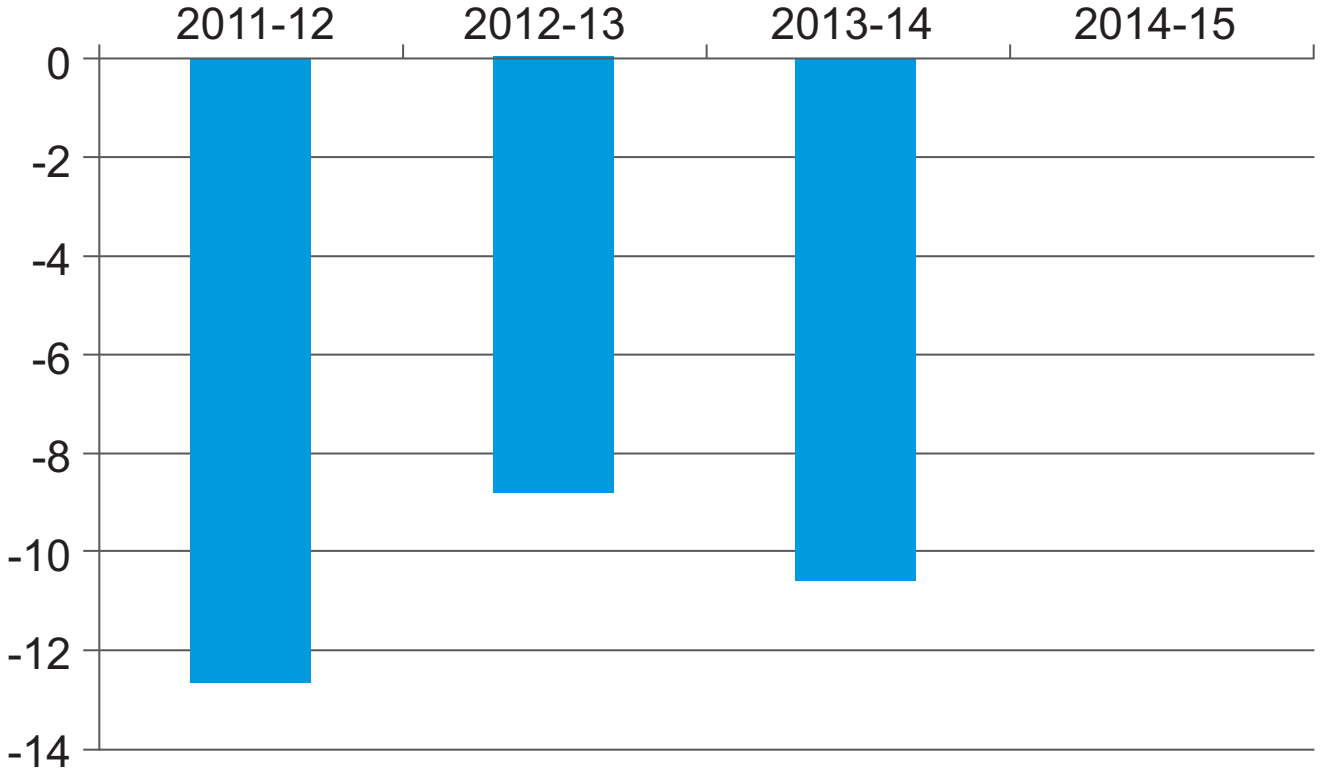
Figure 18 - Real terms decreases each year to health revenue budgets (%)



Source: Wales Audit Office analysis of Welsh Government budgets
Note: The figure for 2011-12 is based on the Final Budget 2011-12, published in February 2011, plus further funding set out in supplementary budgets. The figures for 2012-13 to 2014-15 are based on the Final Budget 2012-13 published in December 2011.

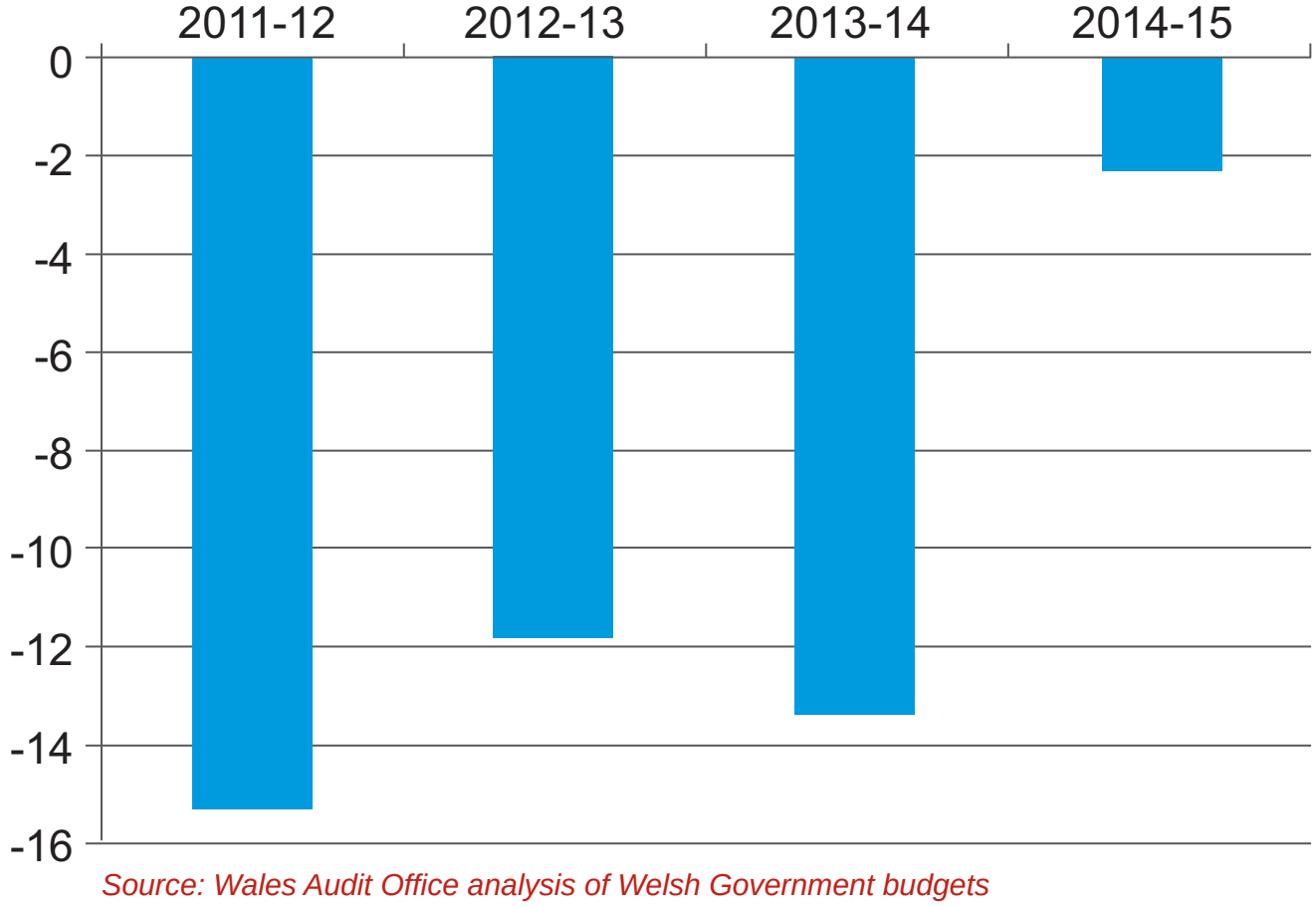
3.3 In common with other parts of the public service, the largest cuts fall on capital spending. Capital is the funding that NHS bodies use to create or develop infrastructure, such as hospitals, surgeries and other assets. The Welsh Government's budget shows that in cash terms, the capital budgets for health reduce each year other than 2014-15 (Figure 19). In real terms, there is a reduction every year (Figure 20) and the capital budget for health will be around £1.1 billion (36 per cent) lower in 2014-15 than 2010-11.

Figure 19 - Cash terms reduction to health capital budget year on year (%)



Source: Wales Audit Office analysis of Welsh Government budgets

Figure 20 - Real terms reduction to health capital budget year on year (%)



Source: Wales Audit Office analysis of Welsh Government budgets

There is a significant gap between the funding required to meet expected demand and cost pressures and actual budgets

3.4 The Five Year Framework sets out the estimated demand and inflationary pressures facing the NHS to 2014-15. The Five Year Framework sets out 'low-cost' and 'high-cost' scenarios. Since the forecasts were produced, inflation forecasts have been revised upwards quite significantly. Therefore, the 'high-cost' scenario is likely to better reflect the actual cost pressures on the NHS, but even the high-cost scenario may understate the true funding gap. Figure 21 updates the position reported in our report, *A Picture of Public Services 2011*, to include the figures from the Welsh Government's final 2012-13 budget and to take account of additional funding from reserves in 2010-11 and 2011-12. Using 2010-11 as a baseline, we estimate that the NHS faces a funding gap in the order of £873 million by 2014-15.

Figure 21 - Funding gap based on NHS Five Year Framework and 'NHS Delivery' line from Welsh Government budget

Revenue (millions)	2010-11	2011-12	2012-13	2013-14	2014-15
NHS Delivery budget	5,467	5,500	5,492	5,507	5,497
Cost pressures in low-cost scenario	3.7	2.6	2.6	2.6	2.6
Cost pressures in high-cost scenario	4.4	3.3	3.8	4.1	4.4
Funding required in low-cost scenario	*	5,609	5,755	5,905	6,058
Funding required in high-cost scenario		5,647	5,862	6,102	6,371
Cumulative funding gap in low-cost scenario	*	-109	-263	-398	-561
Cumulative funding gap in high-cost scenario	*	-147	-370	-595	-873
Year-on-year funding gap in low-cost scenario		-109	-154	-135	-163
Year-on-year funding gap in high-cost scenario		-147	-223	-225	-278

Source: Wales Audit Office analysis based on NHS Five Year Framework forecasts and figures from the Welsh Government's final budgets and supplementary budgets. The 2010-11 published NHS Delivery budget figure was £5,506 million but has been adjusted to £5,467 million for non-cash items. The figures for 2011-12 include the additional funding allocated in the June 2011 and February 2012 supplementary budgets, which helped to reduce the gap within the year.

3.5 While the Five Year Framework has set out cost forecasts underpinned by detailed analysis, the Welsh Government has recently been reporting the cost pressures on the NHS using a different set of figures. In its narrative to the draft budget, the Welsh Government estimated indicative cost pressures of around four to five per cent a year; with savings required in the order of £250 million a year. These figures suggest that the NHS faces a larger challenge than outlined in our report *A Picture of Public Services 2011*. In particular, if the annual pressures on the NHS in 2011-12 are in the order of £250 million a year, as set out in the National Finance Agreement and budget narrative, it will need to reduce costs by around £1 billion between 2010-11 and 2014-15.

The NHS faces a major challenge to manage within budget in the short term

3.6 The funding gap is potentially larger than suggested by either estimates. Those figures are based on the NHS bodies starting with a clean slate. However, four health boards collectively start the year needing to find around £24.4 million to replace the funding 'brokered' to 2011-12 from future years. Further, the estimates assume that each year the NHS bodies are able to sustain all of their savings from the previous year. As Part 2 showed, in 2011-12, NHS bodies had to ramp up the level of non-recurrent savings at the end of the year. To make up the gap left by the non-recurrent savings, NHS bodies will need to make an additional £38 million savings.

3.7 It is likely that the NHS will find it increasingly difficult to continue to make large savings in transactional areas, such as procurement. With two years of financial pressures, it is likely that many of the easy-to-deliver 'low-hanging fruit' have already been exploited. The fact that NHS bodies needed to ramp up the level of non-recurrent savings at the end of 2011-12 is a sign that they are finding it hard to make sustainable recurrent savings in the short term. NHS bodies will therefore need to increasingly look to more fundamental and transformational changes to services in order to achieve the necessary savings.

There are positive signs that the NHS is prepared to take the tough choices needed to deliver long-term change but the goal of improving quality and maintaining levels of service and jobs seems challenging

The ambition set out in the Five Year Framework of delivering the necessary savings while improving quality and sustaining levels of service and jobs looks increasingly optimistic

3.8 The Welsh Government is pressing health boards and trusts to deliver on their savings plans. The Five Year Framework sets out an ambition that the NHS deliver the necessary savings at the same time as improving quality and sustaining the level of services and jobs. In practice, that goal gives the NHS limited scope to act to reduce costs.

3.9 The Five Year Framework is sound in asserting that quality must be a priority despite the financial pressures. Delivering poorer-quality services, with worse outcomes or higher-adverse incidents and infections is not acceptable. It is also self-defeating as a reduction in quality potentially ends up creating extra demand to rectify mistakes as well as, potentially, clinical negligence claims. However, there is a trade-off between the pace and scale of quality improvement

and the investment required to deliver those improvements. It is therefore positive that across 2011-12, despite the financial pressures, the NHS made improvements across a range of quality areas, including reducing levels of hospital-acquired infections.

3.10 Overall NHS bodies have appeared to maintain levels of service, as measured by the length of time people wait for elective treatment. The proportion of patients waiting more than 26 weeks for treatment has stayed at a fairly constant six per cent over the past year (against a target of five per cent) and the number of patients waiting for more than 36 weeks has reduced from 5,077 in 2010-11 to 1,614 in 2011-12. In addition, NHS bodies managed to sustain performance in terms of the length of time people wait for treatment in accident and emergency with 89 per cent of patients waiting less than four hours in 2011-12 compared to 88 per cent in 2010-11.

3.11 Across 2011-12, the number of WTEs working in the NHS increased, but it is unlikely that such a position can be sustained. With pay accounting for a significant proportion of NHS spending, staff cost is the single-largest area of cost to the NHS and is the single-largest area of overspend. Despite a pay freeze and reported savings on staffing through workforce modernisation, net staffing costs have risen considerably ahead of plan. It is hard to see how the NHS can live within its means and meet the ambition of sustaining levels of jobs in future years. That said, reducing staffing costs does not necessarily mean making people redundant. But it may mean looking at reducing some staff hours, greater use of flexible working and redesigning work so that it can be managed by fewer people or by staff at lower grades.

3.12 As the NHS addresses the challenge of reducing its staffing costs, it will need to do so in a planned way in order to manage risks to service levels and quality. The risk is that, in the absence of a strategic approach, health boards and trusts adopt an ad hoc approach, through recruitment freezes and vacancy management, where the primary goal is to make short-term savings rather than take a whole-system approach to managing the impact on patients. Indeed, such approaches can even cost more where they lead to NHS bodies having to take on more expensive locum and agency staff to fill gaps. The Welsh Government has recently launched a new workforce framework, *Working Differently – Working Together*, which will be underpinned by local workforce planning. That framework recognises the need for a whole-systems approach. Notably, it does not repeat the Five Year Framework's ambition of maintaining job levels. It explicitly sets a goal of reducing management costs and also identifies the challenge of ensuring workforce costs are affordable.

3.13 NHS bodies are developing three-year service and financial plans to ensure that the identified financial challenge can be met. It will be important that these plans are robust and deliverable. In particular, the plans will need to link the financial and service delivery plans with robust workforce plans to manage the risks that changes in the workforce may have on levels of service and quality.

The NHS has struggled to deliver the required transformation of services in the past but there are signs that it is now prepared to take the tough choices needed to make the NHS financially sustainable and to improve the quality of services

3.14 The sustainable solution to the financial challenges facing the NHS is to transform the way that NHS services are delivered. As this report has shown, there is some doubt as to whether the local savings plans are delivering the scale of savings that are required to get

the NHS through an unprecedented period of public funding constraint. The major potential for releasing savings and also, most importantly, improving care, are to be found in reshaping the pattern and methods of delivering health services.

3.15 Our report, *A Picture of Public Services 2011*, comments on the track record of the NHS in delivering reform of services and the difficulties it has faced in the past. Since we published our report, there have been several significant developments. In particular, the Welsh Government published *Together for Health: A Five Year Vision for the NHS in Wales* in November 2011. The vision reaffirms some of the key elements of reform that have previously been set out in Welsh Government visions for the NHS, including:

- a focus on keeping people out of hospital through health prevention;
- treating patients in community settings and in their own homes;
- developing centres of excellence for specialist care to concentrate expertise; and
- integrating health and social care services.

3.16 The key difference between the current drive for reform and previous efforts is the growing recognition that the status quo is simply unaffordable. *Together for Health* clearly identifies the need for 'a relentless quest for value for money'. As part of delivery, the Welsh Government will develop a new financial framework to support financial planning. The Welsh Government has committed to a review of the financial regime, which it intends will be wide-ranging and lead to improvements across the financial system in the NHS. Also, each NHS body will develop a budgeting system with greater clinical involvement in financial decision making. Such a system is an improvement. Clinical decisions and actions drive many of the costs in the NHS. Therefore, engaging clinicians in financial decision making and encouraging greater ownership of the financial challenges should help to drive forwards sustainable reform.

3.17 In moving forwards, the NHS also faces the challenge of finding the funding to support the service reconfiguration. With a real terms 36 per cent cut in capital funding over the current spending period, the NHS will need to find ways to use the assets it already owns in new ways to reflect new patterns of service delivery. It will also need to explore alternative methods to funding new facilities needed to deliver the reshaped services. Since 2007, the Welsh Government has had a moratorium on using the Private Finance Initiative in the NHS, so that is not available as an option to fund new facilities. However, the recently announced Wales Infrastructure Investment Plan provides a framework for future capital investment decisions and the Department will need to ensure that any new funding proposals align with the priorities set out in that Plan.

3.18 The NHS faces particular challenges as, unlike local government, NHS bodies are unable to borrow to fund capital developments and pay back the borrowing from revenue. In any case, the pressure on revenue is such that NHS bodies would struggle to find the revenue funding to pay back borrowing, although they could potentially use savings generated by the new ways of working. There is some funding available through the Welsh Government's Invest to Save programme, but it is relatively limited compared to the scale of the challenges. In 2010-11, NHS Invest to Save was around £7.5 million, £3 million of which related to a voluntary early exit scheme, and the Finance Minister recently announced £6.6 million for 2011-12.

3.19 There is also a revenue challenge in funding the new ways of delivering the services. In some instances in the past, changes have been made by introducing a new service to run in parallel with the existing service. In future, the squeeze on revenue funding may make this option unfeasible and NHS bodies will need to prepare for managing the risks associated with stopping an existing service and migrating to a new way of working. Clinical engagement and leadership will be essential in delivering such difficult changes and in helping patients to understand and adapt to the new approaches.

3.20 NHS organisations will be coming forwards with plans for reforming the way services are configured and delivered. The Welsh Government has set up a national clinical forum to review the plans. Once they are agreed, the major challenge then becomes delivering the necessary change and showing the leadership required to engage the public and staff in helping to put the NHS on a sustainable footing. Making the necessary system-wide changes will need widespread support from other sectors, notably, local government and the voluntary sectors, as well as support and engagement from the public, patients and their representatives. As we say in our report, *A Picture of Public Service 2011*, the NHS will need to use the opportunity afforded by the new political cycle following Assembly elections in 2011 and local government elections in 2012, to move forwards with the difficult changes that are needed.

Appendix 1 – Audit methods and technical notes

Methods

Data analysis: This report is primarily based on analysis of financial information from published budgets, and the monitoring return forms that the health bodies provide to the Welsh Government each month. It also draws on other financial data, including:

- Welsh Government data on the funding allocated to health bodies at the start of the year and the end of the year;
- health bodies' audited accounts; and
- HM Treasury's *Public Expenditure Statistical Analysis* (PESA).

Document review: In interpreting the financial data we have also drawn on published strategic documents specifically related to the NHS in Wales. These include the NHS Five Year Framework and *Together for Health: A Five Year Vision for the NHS in Wales*.

Technical notes

Health budgets: The overall figures used in this report relate to 'health revenue budgets' or 'health capital budgets'. This term refers to all of the revenue or capital funding identified in the Welsh Government's budget that is allocated to health. It therefore includes both the funding for NHS bodies and the central health funding for the Department. It does not include any of the departmental budget specifically allocated for social services or children's services.

Real terms: This report includes figures on the 'real terms' budget. 'Real terms' involves factoring inflation in to the analysis. For public sector budgets, it is accepted practice to use the UK Government Treasury's GDP deflator series, which sets out the rate of inflation in the past and forecasts the rate of inflation for future years. For this report, we have used the set of deflators issued by the Treasury in December 2011. The inflation figures for the years covered in this report are set out below.

2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
3.31	2.3	3.00	1.73	2.75	2.60	2.70	2.50	2.50

Funding gaps: This report includes an analysis of the funding gaps the NHS faces, based on forecasts of the cost pressures in the NHS. However, there is some uncertainty about those pressures. We have drawn on two main sources: the NHS Five Year Framework and the National Finance Agreement, which identify specific and overall cost pressures each year based on a mix of national and locally supplied data. Both forecasts cover a range of detailed elements, including pay and non-pay and take account of specific NHS inflationary indexes. To calculate funding gaps, we have used the NHS Delivery line from the health budget. We use this part of the budget because it covers the funding for the NHS services to which the cost pressures apply.

Health boards: Legally the health boards are known as local health boards. However, since reorganisation they have had dispensation from the Welsh Government to refer to themselves as health boards – this report does the same.

Appendix 2 – NHS bodies' 2011-12 financial performance

This appendix sets out more detail on individual NHS bodies' 2011-12 financial performance and can be read in parallel with Part 2 of the main report.

In 2011-12, there was an in-year funding gap in the order of £280 million to £380 million at the start of the year

Part 2 of the main report assesses the in-year NHS funding gap to be somewhere between £280 and £380 million based on Welsh Government data. At the start of the year, the individual NHS bodies estimated an in-year gap of £279 million, the lower end of our calculations. NHS bodies also had an underlying deficit from 2010-11 of £187 million. In order to bridge the in-year gap and eradicate the underlying deficit, NHS bodies identified a total funding gap of £466 million.

The NHS bodies put in place savings plans to help bridge the funding gap and their initial savings targets as per their months 1 to 3 monitoring returns are set out in Exhibit 1 below.

Exhibit 1 - NHS body 2011-12 initial savings targets

NHS body	Initial savings target (£ million)
Abertawe Bro Morgannwg	43
Aneurin Bevan	52
Betsi Cadwaladr	57
Cardiff and the Vale	53
Cwm Taf	26
Hywel Dda	43
Powys	13
Velindre NHS Trust	2
Public Health Wales NHS Trust	3
Welsh Ambulance NHS Trust	7
Total	**300**

NHS bodies reported savings of £285 million in 2011-12 but received additional funding of £157.4 million from the Welsh Government to address cost pressures and achieve break-even

During the financial year, as is usual, various adjustments to the allocation were made by the Department to reflect funding issued from centrally held programme budgets and revisions to estimates of certain capital costs and provisions.

In addition, the NHS bodies have reported the achievement of significant savings in the year as set out in Exhibit 2.

Exhibit 2 - NHS bodies reported savings

NHS body	Initial savings target (£ million)	Final savings targets (£ million)	Savings reported (£ million)
Abertawe Bro Morgannwg	43	43	37
Aneurin Bevan	52	52	49
Betsi Cadwaladr	57	58	45
Cardiff and the Vale	53	59	59
Cwm Taf	26	31	27
Hywel Dda	43	43	43
Powys	13	13	13
Velindre NHS Trust	2	2	2
Public Health Wales	3	3	3
Welsh Ambulance	7	8	8
Total	**300**	**312**	**285**

The estimated in-year funding gap of £279 million would therefore have been covered by reported savings of £285 million. This was a significant achievement but was not enough to cover the total funding gap which includes the underlying deficit. The reported savings have also not been audited and many may not be cash-releasing but represent efficiency gains or cost avoidance measures, rather than a true decrease in expenditure. It is a complex picture and notwithstanding the savings reported, it was clear during the financial year that health boards would require additional funding to achieve their financial targets.

The Welsh Government agreed that funding of £133 million would be allocated in October 2011, of which £103 million would be recurrent (ie, will be included in funding allocations for future years), to recognise the cost pressures on health bodies. It was agreed that central reserves would fund £93 million of this uplift – £63 million recurrently plus £30 million as part of a tapering package to Hywel Dda – with the remaining £40 million funded from the Department.

In addition, Cardiff and the Vale Health Board received additional funding of £12.25 million, with £12 million as repayable brokerage from 2012-13 and 2013-14 resource allocations equally. This support, together with additional planned savings of £2.5 million, enabled that health board to break-even. In return, the health board was required to establish and keep in place a dedicated ‘turnaround‘ team, and to submit a profiled financial plan for months 9 to 12 by the end of November 2011 and a financial and savings plan for 2012-13 by the end of February 2012.

By the end of February 2012, it remained apparent to a number of health boards and the Department that even after the additional October funding, and the reported achievement of substantial savings, some health boards would still not be able to contain their net expenditure within their revised resource limits.

On 6 March 2012, the Minister for Health, Social Services and Children, wrote to the chairs of the health boards offering further financial support. This support would be provided as an ‘advance’ or ‘draw forward’ against a health board’s 2012-13 resource allocation, uplifting the resource limit to a level which would allow health boards to meet their statutory financial targets. Three health boards took up the offer: Aneurin Bevan (£4.5 million), Cwm Taf (£4 million) and Powys (£3.9 million). As a result, they will not be able to make use of this facility again in 2012-13.

The Chief Executive of NHS Wales has commissioned external reviews of the financial management arrangements of each health board in receipt of this support. Work is also being done with Betsi Cadwaladr and Hywel Dda Health Boards to support their financial planning.

The additional October allocation to Cardiff and Vale, and March allocation to Aneurin Bevan, Cwm Taf and Powys Health Boards were made specifically to ensure that they achieved their financial targets.
To highlight this, the Auditor General has placed a substantive report (alongside his audit opinions) on the accounts of each of those health boards.

A summary of the additional funding received by each NHS body in the year is set out in Exhibit 3.

Exhibit 3 - Summary of additional funding received in 2011-12

Health board	October 2011 (recurrent uplift)	November 2011 (primarily to achieve financial target)	March 2012 (to achieve financial target)	Total funding
Abertawe Bro Morgannwg	£17 million	-	-	£17 million
Aneurin Bevan	£17 million	-	£4.5 million	£21.5 million
Betsi Cadwaladr	£17 million	-	-	£17 million
Cardiff and Vale	£17 million	£12 million	-	£29 million
Cwm Taf	£17 million	-	£4.0 million	£21 million
Hywel Dda	£33 million	-	-	£33 million
Powys	£15 million	-	£3.9 million	£18.9 million
Total	**£133 million**	**£12 million**	**£12.4 million**	**£157.4 million**
Central reserves	£93 million	-	-	£93 million
Department	£40 million	£12 million	£12.4 million	£64.4 million
Total	**£133 million**	**£12 million**	**£12.4 million**	**£157.4 million**

The Welsh Government has changed its approach to provide £63 million of this additional funding on a recurrent basis and use brokerage to reinforce a tougher message to NHS bodies

The health boards each reported their forecast out-turn for the year on a monthly basis to the Welsh Government. The pattern of forecasting is shown in Figure 16 in the main report and shows the large overspends forecast at the start of the year reducing at month 7 when the additional recurrent funding was allocated in October. Further reductions in forecast overspends can be seen at the year-end as the March funding is reflected.

The additional funding provided in November 2011 and March 2012 was provided as a ‘draw forward’ of future years’ funding and therefore future funding will be reduced by the same amount. This is a specific change in approach for the Department. The funding to assist health boards in achieving their financial targets will no longer be provided without conditions but instead recipients are required to pay it back, in effect by receiving a corresponding reduction in funding in future years. In addition, those receiving March funding will not be able to request brokerage next year.