Provider Sustainability Guidance

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Policy	Estates
HR / Workforce	**Commissioning**
Management	IM & T
Planning /	Finance
Clinical	Social Care / Partnership Working

Document Purpose	Best Practice Guidance
Gateway Reference	15172
Title	Provider Economics - Provider Sustainability Guidance
Author	DH and NHS Confederation
Publication Date	14 Dec 2010
Target Audience	PCT CEs, NHS Trust CEs, SHA CEs, Foundation Trust CEs
Circulation List	PCT Chairs, NHS Trust Board Chairs
Description	This guidance and the associated assessment framework is designed to help commissioners and providers better understand the economic implications of commissioning decisions on the healthcare provider base. It is intended to identify and provide guidance on the main questions that are relevant to assessing the impact of commissioning changes on provider economics.
Cross Ref	N/A
Superseded Docs	N/A
Action Required	N/A
Timing	**N/A**
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For Recipient's Use	

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Introduction

Purpose:

This guidance and the associated assessment framework is designed to help commissioners and providers better understand the economic implications of commissioning decisions on the healthcare provider base. It is intended to identify and provide guidance on the main questions that are relevant to assessing the impact of commissioning changes on provider economics.

When considering making a change to the way in which healthcare is organised within a health economy, this material should be used in conjunction with a number of other tools and inputs from the world class commissioning suite and local sources. These should include analyses that provide insight into hospital cost structures and a discussion of how different categories of costs change under different commissioning scenarios.

The guidance has been prepared to help commissioners understand the impact of their decisions on a provider's costs and sustainability. The assessment framework has been developed as a tool to guide the process and ensure that the key provider economics issues have been explored before decisions are made.

It is assumed that before using the assessment framework and the guidance, individuals will have considered the rationale for proposed commissioning changes, identified the providers who are likely to be impacted by change and begun an extensive engagement process with providers, clinicians, and the public.

The box opposite summarises the broad categories of issues that the assessment framework and this guidance cover.

Scope of assessment framework and guidance

- Understanding change: what is the rationale for change. has it been given full and proper consideration and have key risks been identified?
- Quality of provision: how will the quality of services be directly and indirectly affected by the change?
- Finances of the provider: how will the change affect the finances of the affected provider(s)?
- Cost structures: have the cost structures (fixed versus variable costs) of the provider been considered?
- Scale effects: how does the change impact the scale of provision and does this affect costs?
- Cost of change: what are the costs of implementing the change?
- Broader impact of change: what are the effects of the change on other parts of the affected providers and also on indirectly affected providers?

The guidance explores each of these issues in turn providing Q&A and further information on how the tools developed for provider economics can provide insight.

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Provider Sustainability Assessment Framework

A. Understanding change	Has a sound rationale for the proposed change been established? Have all affected parties been consulted for their views and evidence for change? Have both the short term and medium term effects been considered? Has a risk assessment been undertaken and key risks identified?
B. Quality of provision	Have the direct and indirect effects of reorganisation on the quality of the particular service provided been considered? Has the effect on the quality of other services been considered?
C. Finances of providers	Has the impact of the change on affected providers in terms of the difference between unit costs and tariff of the relevant services (i.e. provider's finances) been considered? Has a benchmarking exercise taken place between affected providers and other providers? Has the impact on long term provider sustainability been explored?
D. Cost structures	Have fixed costs been considered? Have semi-fixed costs been considered? Have stranded assets been considered?
E. Scale effects	Has assurance been given that the new service volumes will be sufficient to ensure clinical and operational quality standards at both service line and intervention level? Has assurance been given that the new service volumes are sufficient to provide a cost effective service?
F. Costs of change	Have the staff costs of the change been considered? Have the non-staff costs of the change been change considered? Have transition costs been considered?
G. Broader impacts of change	Have clinical and cost linkages to other services/areas been considered? Has the indirect effect of the change on other providers been considered? Has the impact of the change on choice, access, innovation and future competition been considered?

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Provider Sustainability Guidance
Understanding change

What questions should be asked as part of the reorganisation process?

- Has a sound rationale for the proposed change been established?
- Have all affected parties been consulted for their views and evidence for change?
- Have both the short term and medium term effects been considered?
- Has a risk assessment been undertaken and key risks identified?

Why are these questions relevant?

(1)Has a sound rationale for the proposed change been established? & (2)Have all affected parties been consulted for their views and evidence for change?

It is assumed that before using the assessment framework and the guidance, individuals will have considered the rationale for proposed commissioning changes, identified the providers who are likely to be impacted by change and begun an extensive engagement process with providers, clinicians, and the public. These are essential steps in the commissioning process.

(3) Why is it important to consider both immediate and medium term effects?

Some costs and benefits from a reorganisation of services will occur immediately, e.g. new buildings, redundancy payments or increased quality of service. Other costs and benefits, such as reduced operating costs, and the sale or reuse of buildings may take time to arise and may not be easy to evaluate. As such it may only be in the medium term that the full benefits of reorganising services are realised, but commissioners should assure themselves of the viability of a change under both circumstances.

Provider Sustainability Guidance
Understanding change

(4) Are long term costs important?

The costs and benefits of any change will be complex and unique to the particular service being considered. As a result the time profile of costs and benefits may differ substantially between Service Lines. However across all services and reorganisations the further into the future you look the greater the uncertainty over costs and benefits will be. Therefore any decision should be stress tested by assessing the impact of greater uncertainty over costs and benefits over a longer time horizon.

(5) Has a risk assessment been undertaken and key risks identified?

It is essential that a risk assessment of the proposed change is undertaken and that key risks arising from the proposed reorganisation is identified.

Provider Sustainability Guidance
Understanding change

How the Provider Economics tools can be used to help answer these questions:

How should the assessment framework and guidance be used to consider both short and medium term effects?

The Assessment Framework provides guidance on the key issues such as fixed costs and stranded assets that are the main differentials between short term and medium term costs. Providers and commissioners should assure themselves that these issues have been covered in detail as part of the engagement process.

How can you estimate short term and medium term effects?

The Provider Economics Commissioning Impact Assessment Model provides two cost outputs. These can be used to provide an indication of both short term and medium term costs of provision of the reorganised service. The two cost outputs are:-

1. **An analysis of fixed and variable cost.** This methodology assumes that the variable costs of provision will adjust to new activity levels; but fixed costs of operation will still have to be met. This analysis provides a good indication as to the likely short term effects of a service line change, but does not include the one off costs of reorganisation e.g. purchase of new equipment or the costs of any redundancies.
2. **An econometric analysis of cross sectional data.** This methodology compares all providers of a service and uses this to produce an estimate of the costs of provision for the chosen provider at the new activity levels once local factors such as estates and other organisation specific costs have been taken into account. This method provides an indication of the costs of provision once a provider has fully adjusted to its new operating size and is thus a reasonable indicator of the medium term costs of provision.

It should be noted that the model can only provide an indication of the costs of operation both in the short and medium term. Further assurance and more robust estimates should be sought as part of the engagement with providers.

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Quality of provision

What questions should be asked as part of the reorganisation process?

- Have the direct and indirect effects of reorganisation on the quality of the particular service provided been considered?
- Has the effect on the quality of other services been considered?

Why are these questions relevant?

(1) How can changes in volume affect the quality of services provided?

Reducing the volume of activity undertaken may lead to a change in the quality of services provided. Reduced volume may lead to an increased unit cost because the provision of most services will incur some fixed costs. In some cases this may place additional pressure to reduce quality levels towards the minimum expected standards, particularly if per unit revenue remains constant as unit costs increase. Over longer time horizons lower volumes may lead to de-skilling and potential issues with retention and training that may affect quality.

(2)How might changes in volume in one service affect the quality of another service?

It is possible for a reduction in activity in one line of service to have a knock on effect in the ability of another service to maintain quality standards. One reason for this is that the two services may rely on the same clinical or auxiliary services hence if a decision is taken to reduce the volume of activity in one of the services may reduce the quantity or quality of the resources available to another service might be affected. Equally if a profit making service in a provider were to be cut back other loss making services in that provider may come under increased cost pressures that may impact on quality levels.

(3) Can an increase in volume present quality issues?

An increase in volume may also present quality issues. As volume increases utilization of assets will increase, as this happens providers should consider investment in additional resources in order to maintain service standards and safety.

Provider Sustainability Guidance

Quality of provision

How the Provider Economics tools can be used to help answer these questions:

How can you estimate whether there is a potential quality issue as a result of a proposed reorganisation of services?

Commissioners should seek clinical advice from their providers and independent sources as part of the engagement process to ensure that the quality of services provided will still meet, or will improve, service standards following the change. The provider economics model will indicate when the volume of activity in a service line has fallen below the level provided by only the smallest 10% of NHS organisations by volume as a result of the proposed reorganisation and flags up where there are recommended minimum volume levels for a particular procedure or population. This can be seen in the screenshot from the model below.

Model provides guidance on minimum volumes for the service line selected

Possible quality implications of decision

Possible dependent service lines that may be affected	Consider at least the following service lines
Dependencies	Adult Critical Care, Emergency and Urgent Care, Trauma and Orthopaedics

Information on minimum activity level	Consider at least the following areas within service line
Minimum activity levels	Amputation of lower limb (>11 treatments per year per hospital), Cholecystectomy (>109 cases per year per hospital), Cholecystectomy (>168 cases per year per hospital), Oesophageal Cancer (>3 operations per surgeon per year), Pancreatic Cancer (>46 cases per surgeon per year)

Implications of change		Activity	% of total
Level of activity of bottom decile of sample=280	2008/09	1,100	0.03%
	After	682	0.02%
	Change	-418	-38.00%

The model provides information so that the user can assess whether the new level of activity has fallen below the level provided by only the smallest 10% of NHS organisations

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Finances of providers

What questions should be asked as part of the reorganisation process?

- Has the impact of the change on affected providers in terms of the difference between unit costs and revenue of the relevant services (i.e. provider's finances) been considered?
- Has a benchmarking exercise taken place between affected providers and other providers?
- Has the impact of the change on long term provider sustainability been explored?

Why are these questions relevant?

(1) How can a mismatch between tariff and unit cost occur?

Under payments by results (PbR) the income a provider receives for undertaking a procedure is equivalent to the national average cost of undertaking a procedure, including non medical costs such as food, and estates, with additional adjustments for unavoidable market forces costs and excess bed days. The true costs faced by an individual provider may be considerably different as an individual provider may be very different from the average provider due to factors including estates, scale of operation and case mix.

It is therefore incorrect to assume that either the resources released from a trust as a result of a reduction in activity will be equivalent to tariff multiplied by volume, or the costs of providing a service are calculated by multiplying tariff by commissioned activity.

(Cont)

Provider Sustainability Guidance
Finances of providers

(2) How does a change in volume affect unit costs?

In most service lines there will be three types of cost, Fixed Costs, Semi-Fixed Costs and Variable Costs.

- Fixed costs are items of cost that must be undertaken whatever the level of activity is (e.g. building maintenance)
- Semi-fixed costs are items of cost that are for a short period fixed but over a medium term time horizon can be adjusted to meet the volume of demand (e.g. staff)
- Variable costs are items of cost that are purely activity related (e.g. medications)

In general as activity levels increase the fixed cost elements do not increase and hence the average cost of providing services fall. However in some circumstances it may be possible for average costs of provision to increase with additional activity, for instance if new fixed resources have to be employed and are not fully utilised or if there is no spare capacity to cover for periods of high demand.

(3) What is the implication of tariff being more than a provider's unit cost?

If the average income received for a given level of activity is greater than unit cost of providing the service, this implies that the organisation concerned is able to make profit on providing a service. This will be the case in many services and may be used by the provider to improve the quality of services provided, to subsidise other Service Lines or to generate a surplus

(4) What is the implication of tariff being less than a provider's unit cost?

If the average income received for a given level of activity is less than unit cost this implies that the organisation concerned is not able to cover the costs of providing the service at this level of activity. In order to sustain provision at the present level of activity a provider must improve efficiency and reduce its costs, or use income from more profitable services in order to cover the costs of the service. While it is usual for many Service Lines to be cross-subsidised from other lines of service it may be sensible to use this knowledge to prioritise these areas for productivity gains and/or to de-prioritise them for service development

Provider Sustainability Guidance

Finances of providers

(5) Why is it important to undertake a benchmarking exercise?

It is important to understand whether other providers will be affected in a similar way (in terms of volume, cost and quality) by the change proposed or whether this provider unique. If other providers react differently it will be important to consider why and whether there are aspects from that provider's approach that can be adopted by local providers.

(6) *How can a reorganisation of services affect provider sustainability?*

The nature of hospital cost structures and co-dependencies across services mean that even small changes in contracting patterns can significantly affect the sustainability of local markets. It may be that the chosen service line within in a provider has operating costs that are substantially below tariff, resulting in additional income that can be used to support less efficient service lines. If changes are made to this profitable service line, it could affect the ability of the organisation to provide a less profitable service line or if changes are substantial it may push the organisation towards a deficit position which may affect the long run viability of the provider. On the other hand there could equally be scenarios where a change might be assumed to be de-stabilising, but actually has less impact on unit cost or sustainability than anticipated. The tools developed for this project are designed to help commissioners

Provider Sustainability Guidance

Finances of providers

How the Provider Economics tools can be used to help answer these questions:

How can the provider economics tools be used to gauge whether income received from a service line is equal to the costs of provision once reorganisation of services has been undertaken?

The provider economics model provides outputs on both cost and income expected from a service line for the chosen level of activity. These can be compared to provide an indication of whether the income received from operating a service will be enough to cover the costs of provision. As part of the engagement process around reordering services, commissioners should seek more robust estimates from their providers using the model's output as a benchmark.

Change in income as a result of the refined commissioning decision

Calculated impact of change on tariff income		Value
	2008/09	1,638,673
	After	213,027
	Change	-1,425,646

Predicted impact of change on unit cost		Value (% total)
	2008/09	1,525
	After - Ecnx	1,525
	Change - Ecnx	0
	After - FCVC	3,553
	Change - FCVC	2,028

Predicted impact on total cost		Value (% total)
	2008/09	1,834,257
	After - Ecnx	238,453
	Change - Ecnx	-1,595,804
	After - FCVC	555,624
	Change - FCVC	-1,278,633

Medium term change in costs as a result of the commissioning decision

Short term change in costs as a result of the commissioning decision

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Provider Sustainability Guidance
Cost structures

What questions should be asked as part of the reorganisation process?

- Have fixed costs been considered?
- Have semi-fixed costs been considered?
- Have stranded assets been considered?

Why are these questions relevant?

(1) What is a fixed cost?

In economics, fixed costs are business expenses that are not dependent on the activities of the business. They arise as a result of undertaking any activity in a particular area. This is in contrast to variable costs, which are volume-related. Fixed costs should not be confused with overhead costs (e.g. management, advertising, etc) which do vary with the size of activity.

(2) What is a semi-fixed cost?

Semi-fixed costs are items of cost that are for a short period fixed but over a medium term time horizon can be adjusted to meet the volume of demand (e.g. staff)

(3) Why do fixed costs and semi-fixed costs arise in healthcare?

In many aspects of healthcare there will be some basic costs that will be incurred that are independent of the total activity undertaken, e.g. in order to undertake just one hip operation per year it will be necessary to operate a patient administration system, however if 100 operations were undertaken in a year, while other costs would be incurred, the costs of patient administration system would be unchanged.

(4) Why are fixed costs important?

Fixed costs are important because they are unavoidable, if they are not funded by activity within the service line they arise from they will become an additional cost on other service areas. They also affect how unit costs change over time and activity levels.

(cont)

Provider Sustainability Guidance
Cost structures

(5) What is a stranded asset cost?

A stranded asset is an asset that becomes less utilised, or less valuable, as a result of changes to the way that services are delivered. One example of a potential stranded asset is a wing of a hospital that would sit empty if the provision of care was shifted to an alternative location.

(6) How do stranded assets arise?

A stranded asset cost arises because the asset is likely to continue to incur some cost (e.g. financing costs and/or overheads), however the revenues previously received as a result of utilising the asset no longer accrue. Stranded assets are particularly likely to occur for assets which cannot easily be transferred to other services or sold for a price sufficient to compensate for costs incurred.

(7) Why are stranded assets important?

Stranded asset costs are important for two main reasons:

- Substantial stranded asset costs, if not compensated for, may impact the financial stability of the organisation incurring them (usually the provider that has the stranded asset); and
- From a system management/efficiency perspective, stranded assets may indicate duplication of assets (and hence capital costs) if similar assets are required to deliver services elsewhere.

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Provider Sustainability Guidance

Cost structures

(8) When are stranded asset costs most troublesome?

Stranded asset costs are likely to be larger and more important where:

- Assets and costs are 'fixed' and cannot easily be adjusted with changes in volume or service mix;
- Assets have a long economic life – they are viable for use for a long time into the future (i.e. have positive current value);
- It would be expensive to replace/reproduce the services provided by the asset elsewhere – either (1) the service will be carried out elsewhere and requires the same (expensive) asset, or (2) the service will be carried out elsewhere without the asset, which is higher cost than providing the service using the asset; and
- The asset (and associated cost) is large relative to the total costs of the provider.
- Transporting the asset to a new location is either impossible or would incur large cost

(9) What else should be considered with respect to stranded assets?

As well as considering stranded asset costs from existing assets, you should consider whether the proposed change is likely to create assets that may become stranded in the future (e.g. if the market changes in 5 years time).

Provider Sustainability Guidance
Cost structures

How the Provider Economics tools can be used to help answer these questions:

How can you estimate the fixed cost of providing a service?

The Provider Economics Commissioning Impact Assessment Model sets out aggregate data for fixed and variable costs for a service line. These can be used as an indication of the impact of fixed costs on a service line. Providers will often be able to provide further information from their service line reporting systems

Cost and general financial implications

Information on cost structure from modelling	Unit of measurement	Point estimate
Econometrics analysis	*% change in unit cost as a result of a 10% decrease in activity*	
Fixed and variable cost analysis	*Proportion of fixed costs*	*20%*

The model provides an estimate of the typical fixed and variable costs faced within the chosen service line in the summary output

Provider Sustainability Guidance

Cost structures

How the Provider Economics tools can be used to help answer these questions:

How can you avoid large stranded asset costs?

When considering a reconfiguration of services commissioners and providers should consider whether assets that become redundant or under utilised as a result of the change could be, **Scaled-down; Sold at a reasonable value; or Transferred to another service**.

If none of these options are available it may be sensible to revise the reconfiguration strategy, depending on the size of the stranded asset. However in many reconfiguration exercises stranded assets will occur.

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Provider Sustainability Guidance
Scale effects

What questions should be asked as part of the reorganisation process?

- Has assurance been given that the new service volumes will be sufficient to ensure clinical and operational quality standards at both service line and intervention level?
- Has assurance been given that the new service volumes are sufficient to provide a cost effective service (i.e. the provider is above minimum efficient scale)?

Why are these questions relevant?

(1) Is there a minimum volume required to ensure standards and quality?
In healthcare it is frequently the case that a baseline level activity will be required in order to ensure that clinical standards are met, if this level of activity is not present then recruitment retention and the skills base of healthcare professions in the service is likely to decline, and it will not be possible to find resources to maintain equipment and purchase emergent technology.

(2) What is meant by minimum efficient scale?

The minimum efficient scale is the level of service that minimises the unit cost of providing a service. If a provider operates below the minimum efficient scale it will face higher unit costs

(3) Are minimum efficient scale and the minimum scale required to ensure standards different?

It is likely that minimum efficient scale and minimum scale required for quality will be at different levels. In the majority of cases the minimum volume required to maintain clinical standards will be lower than the point at which unit costs will be minimised. At this point the service will be clinically safe but other providers may be operating a lower cost service.

(cont)

Provider Sustainability Guidance
Scale effects

(4) Why might a service require a provider to operate with surplus capacity?

In many businesses, as utilization of resources approaches 100% the average cost of operating will increase because there is no slack in the system to cover for mechanical failures, staff absence, and periods of extreme demand. In order to cover for these events, it may be cost effective for a provider to operate with some surplus capacity. An example of this is in A&E where, in order to maintain standards in the event of high demand it is often necessary to employ surplus resources.

Provider Sustainability Guidance

Scale effects

How the Provider Economics tools can be used to help answer these questions:

How to judge whether a provider is below the minimum scale to ensure quality

While the Provider Economics Model will indicate when the volume of activity in a service line has fallen below the level provided by only the smallest 10% of NHS organisations (indicating a potential quality risk), commissioners should seek clinical advice from their providers and independent sources as part of the engagement process to ensure that the quality of services provided will still meet required service standards under the levels of activity proposed.

How to judge whether a provider can cover the costs of surplus capacity in order to operate a service

As part of the engagement process commissioners should seek views from providers and independent clinicians as to the level of surplus capacity required in a service line in order to maintain standards and operate efficiently

Model provides guidance on minimum volumes for the service line selected

Possible quality implications of decision

Possible dependent service lines that may be affected	Consider at least the following service lines
Dependencies	Adult Critical Care, Emergency and Urgent Care, Trauma and Orthopaedics

Information on minimum activity level	Consider at least the following areas within service line
Minimum activity levels	Amputation of lower limb (>11 treatments per year per hospital), Cholecystectomy (>109 cases per year per hospital), Cholecystectomy (>168 cases per year per hospital), Oesophageal Cancer (>3 operations per surgeon per year), Pancreatic Cancer (>46 cases per surgeon per year)

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Provider Sustainability Guidance
Costs of change

What questions should be asked as part of the reorganisation process?

- Have the staff costs of the change been considered?
- Have the non-staff costs of the been change considered?
- Have transition costs been considered?

Why are these questions relevant?

(1) What are the non-staff costs associated with changing capacity (i.e. reducing or increasing) following a commissioning change?

These may be the costs of running down an asset, changing the size of an asset (e.g. a large machine for a smaller one), or installing a new asset.

(2) What are transition costs?

Organisational changes that require a change in process, development of a new process, staff training, or establishing new protocols may entail a significant recurrent cost to a provider in the short run that will not be covered by the income received for providing the service. These costs will reduce as the change becomes embedded within an organisation.

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Provider Sustainability Guidance
Broader impact of change

What questions should be asked as part of the reorganisation process?

- Have clinical and cost linkages to other services/areas been considered?
- Has the indirect effect of the change on other providers been considered?
- Has the impact of the change on choice, access, innovation and future competition been considered?

Why are these questions relevant?

(1) Why might changes in one line of service have knock on effects on the provision of other service and how might changes affect the sustainability of the organisation as a whole?

Changes in one service line may impact on the provision of others in three ways. Firstly many services have strong clinical interdependencies between them. A change in one service (both in volume or location) may impact on the clinical ability to deliver another. Second, it may be that two service lines share some common costs e.g. the costs of maintaining a scanner, if one service line is decommissioned the cost may have to be met by the other service line.

Third, it may be that one service line has operating costs that are substantially below tariff, resulting in additional income that can be used to support less efficient service lines. If changes are made to the more profitable service line, it could affect the ability of the organisation to provide a less profitable service line or if changes are substantial it may push the organisation towards a deficit position which may affect long run operations.

(2) Why might other provider's costs be impacted by a commissioning change?

Other providers may be impacted in two key ways as a result of a reorganisation of services in a different provider. First it is not uncommon in many service lines for a provider to depend on another for some part of its services. A reorganisation in this second organisation may have a knock on impact on the ability of the former to provide services. Second a provider may experience changes in activity patters as a result of a reorganisation in a different provider. e.g. If a decision is taken to downgrade a local A&E service and transfer services to a regional hub, GPs, local walk-in centres and other local hospitals may experience increased activity as individuals choose the healthcare that best suits their needs. These secondary impacts must be considered as part of the decision making process.

(cont)

Provider Sustainability Guidance

Broader impact of change

(3) How might commissioning decisions impact on broader health objectives such as choice, competition, innovation and access?

Due to economies of scale, the most efficient reordering solutions for local providers will often require commissioners to consolidate services within a single provider within a local health economy. While this may be the most cost effective solution in the short run, it is likely to result in reduced choice for individuals, increased travel distances for many and may lead to reduced competition and efficiency in the future.

Provider Sustainability Guidance

Broader impact of change

How the Provider Economics tools can be used to help answer these questions:

How to assess whether one line of service is clinically dependent on another service line.

While the provider economics model provides simple guidance as to the potential clinical linkages between service lines, it will be essential to involve clinicians from across all of the potentially affected organisations at the commencement of any service redesign. This will help to mitigate against the possibility of making changes to a service line that impacts on the clinical ability to deliver another service.

The model reports possible dependencies between service lines in the main output

Possible quality implications of decision

Possible dependent s	Consider at least the following service lines
Dependencies	Adult Critical Care, Emergency and Urgent Care, Trauma and Orthopaedics

How to understand whether the costs of providing a service are linked to the costs of providing other services.

By using reference cost data on providers and comparing this to tariff, commissioners should be able to assess whether a service line is providing a subsidy to other service lines. The provider economics model provides a view on this for each organisation and will indicate when changes to one service line may result in issues for other service lines or the organisation as a whole. However because the data used in the provider economics model is based on 2008/9 activity it should only be used as a guide as to where potential issues may exist and where further assurance should be sought.