HM TREASURY

TREASURY MINUTES

Government responses on the Twenty Second, the Thirty Third and the Thirty Eighth to the Forty First Reports from the Committee of Public Accounts: Session 2010-12

Cm 8179 September 2011

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Treasury Minutes on the Twenty Second, the Thirty Third and the Thirty Eighth to the Forty First Reports from the Committee of Public Accounts Session 2010-12

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Twenty Second Report

HM Treasury (HMT)

Excess Votes 2009-10

Report Summary from the Committee

The Committee of Public Accounts scrutinises the reasons behind individual Departments exceeding their allocated resources and reports to the House of Commons on whether it has any objection to making good the reported excesses.

In 2009-10, the Statistics Board breached its cash limit by £251,000. The Government Actuary's Department incurred excesses in the use of resources totalling £747,000, leading to a breach of the Administration Budget by £741,000. The Government Actuary's Department also incurred an excess of £67,000 in its voted cash limit. More specifically:

- The Statistics Board breached its voted Net Cash Requirement limit by £251,000 through weaknesses in its cash management system resulting in a payment to suppliers being authorised at the year end when the Statistics Board's cash limit had already been reached.

- The Government Actuary's Department breached its Net Cash Requirement by £67,000 through a combination of unexpected payments due to an ex-employee under the injury benefit scheme, and to the misalignment of cash management with the working capital requirements of the growing business. It also incurred excess resources of £747,000 as a result of having to provide for future liabilities in respect of the injury benefit award. This excess use of resource also led to a breach of the Administration Budget by £741,000.

In the context of the recent Comprehensive Spending Review, strong and effective financial management and control are more important than ever for Government Departments if they are to avoid exceeding their resource limits. Nevertheless, on the basis of the Committee's examination of the reasons why the Statistics Board and the Government Actuary's Department exceeded their voted provisions for 2009-10, the Committee has no objection to Parliament providing the necessary amounts by means of an Excess Vote.

Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 3

In the context of the recent Comprehensive Spending Review, strong and effective financial management and control are more important than ever for Government Departments if they are to avoid exceeding their resource limits.

Departments must ensure that staff are aware of the voted limits, and the repercussions of a breach, and that controls are in place for the accurate forecasting of income and expenditure to prevent future excesses. Departments cannot decide that incurring an excess vote is an acceptable consequence of failing to maintain appropriate financial control.

1.1 The Government agrees that achieving the spending reductions of around £80 billion in the Spending Review will require a robust approach to spending control.

1.2 The Government also agrees that staff should be fully aware of the voted limits and the consequences of a breach.

1.3 With that in mind, the Government has a number of initiatives in place to help to achieve the spending plans including:

- the revised *Consolidated Budgeting Guidance (CBG)*, sets out the rules for operating within the collectively agreed spending budgets;
- plans for a new Budget Exchange system to replace End Year Flexibility, together with measures to strengthen control of Annually Managed Expenditure (AME);
- a revised *Estimates Manual*, which has its emphasis on in year control of spending and cash, also incorporating the recent implementation of the Clear Line of Sight reforms;
- a drive toward better financial management, as encapsulated in *Managing Taxpayers' Money Wisely: a commitment.*[1] This will include closer monitoring of monthly forecast Departmental spending to try to spot resource and cash flow issues and forestall problems; and
- a revised framework for corporate governance in central Government Departments in which non-executive directors will have a stronger advisory role.[2]

1.4 In the two Departments with Excess Votes:

- the Government Actuary's Department (GAD) has taken steps to reduce the risk of a recurrence of the events of 2005-06, which was caused by a claim arising from a staff grievance and caused the administration budget excess. Future staff grievances are now reported to the management board for appropriate action and risk mitigation.
- the Statistics Board has made improvements in its procedures for cash management and for oversight of its business.

[1] http://www.hm-treasury.gov.uk/psr_managing_taxpayers_money.htm
[2] http://www.hm-treasury.gov.uk/psr_governance_corporate.htm

Thirty Third Report

Department for Health (DH)

National Health Service Landscape Review

Report Summary from the Committee

The Health and Social Care Bill, published on 19 January 2011, proposes a new model for the NHS focusing on patient outcomes. The proposals are intended to transform the NHS in England into a highly devolved, market-based model in which local commissioners and providers of health services are freed from central control, with an increased say for local authorities, patients and the public. The two significant structural changes proposed in the Bill are the abolition of the current structure of commissioners of health services and the regional organisations that oversee them (Primary Care Trusts and Strategic Health Authorities), and the creation of the NHS Commissioning Board and GP commissioning consortia to make commissioning more clinically led. The Government also expects all health service provider trusts to become Foundation Trusts by 2014.

The reform programme will need to be managed alongside the imperative, set in 2009, to secure challenging efficiency gains across the NHS of up to £20 billion by the end of the financial year 2014-15 and the requirement to reduce administrative costs in non front-line organisations by 33% over the same period. Within the context of an increasing health budget, these savings are to be reinvested in the NHS to offset cost increases driven mainly by increasing demand. The Department of Health (the Department) is taking steps to integrate the efficiency plans with the transition to the new NHS model, but it acknowledges that the risks to delivering all of the planned savings have increased in the light of the planned reforms. In particular, the one-off costs and disruption of reorganization at the same time as seeking £20 billion efficiency savings provides an additional challenge to the NHS.

It was clear from the evidence we took that many critical issues have yet to be resolved. Most important, for instance, the Department has not yet got a framework to deal with failure in the system, be it on the provider side or the commissioning side. Establishing strong, effective systems of governance and clear lines of assurance and accountability supported by robust flows of information will be key to ensuring that public money is safeguarded. There is a continuing need to provide accountability to Parliament and for information and assurance to be aligned with new funding channels. There is a natural tension between this and the decentralisation of key funding and spending decisions closer to the ‘front line’, which needs to be reconciled in a way which satisfies Parliament that every pound of taxpayers’ money can be followed and accounted for. The lines of accountability must be explicitly clear.

Ultimate accountability for the performance of GP consortia, and for the money they spend, will rest with the new NHS Commissioning Board and its Chief Executive, Sir David Nicholson (currently the NHS Chief Executive). Consortia themselves have considerable room for manoeuvre in developing their internal structures, but can only function with the Board’s approval. The consortia also have a duty to consult their local communities when planning and commissioning services. They are accountable primarily to the NHS Commissioning Board for their performance.

The Government requires all hospitals to become Foundation Trusts by 2014 or cease to exist as independent entities. They will compete with non-NHS providers. Competition law puts the focus on protecting services rather than providers. This has serious implications for the less competitive NHS hospitals, particularly those with expensive PFI contracts. It is imperative that the Department puts in place clear and transparent policies for dealing with failure of commissioners or providers to ensure patients are protected and value for money is assured.

High quality risk management will be crucial if the change programme is to be delivered to time and budget and to realise its intended benefits, especially during the transition stage. The cost implications of the programme to deliver the reforms are clearly set out. The Department estimates the initial cost of the reforms will be a total of £1.4 billion, mainly redundancy costs, to be offset by a 33% (£1.7 billion) reduction in administrative spending by 2014-15. At this stage there is scope for these cost and savings estimates to change, for example, if GP consortia are reluctant to employ staff from existing NHS commissioning bodies.

It is unusual for the Committee of Public Accounts to examine the progress of reforms at such an early stage, but given the scale of the changes and our ongoing interest in health spending, the Committee thought it important to gain a greater insight into the accountability and value for money issues raised by the reform proposals. The Committee undertook its inquiry on the basis of a landscape review by the Comptroller and Auditor General and and the Committee took evidence from the Department and, at a second hearing, from four expert witnesses: Professor Chris Ham of the King's Fund; Dr Clare Gerada, chair of the Royal College of General Practitioners; Dr Shane Gordon, a GP who is also chief executive of the North East Essex GP Commissioning Consortium, a 'pathfinder' GP consortium; and Jill Watts, chief executive of the private healthcare company Ramsay Health Care UK.

This report provides an overview of aspects of the reforms where Parliament requires clarification and draws out a number of risks associated with the transition to the new model that need to be managed. The Committee intends to review the progress of the reforms at regular intervals and this report signals the sorts of issues the Committee will want to examine in future.

Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 1

The Committee's focus in respect of the health reform programme is on accountability for taxpayers' money. With the health reforms still at an early stage, there are some aspects of the accountability arrangements which have yet to be resolved. There are also a number of risks during the three-year transition period which need to be managed.

1.1 The Government welcomes the Committee's report and findings.

PAC CONCLUSION AND RECOMMENDATION 2

Parliament, and this Committee in particular, needs certainty about who to hold accountable for health spending once the reforms are complete. The different accountability arrangements for commissioners and providers are complex. The Department should provide detailed answers to the following questions:

PAC CONCLUSION AND RECOMMENDATION 2.1

Who will be accountable to Parliament for protecting the interest of taxpayers in a devolved health system?

The respective roles and responsibilities of the Department's Permanent Secretary, the Chief Executive of the NHS Commissioning Board, the regulators, Monitor and the Care Quality Commission, and the Accounting Officers for Foundation Trusts require further clarification, along with the arrangements for securing assurance about the propriety and value for money of local health spending. Whilst the Committee understand that legislation underpinning this accountability has been in place for some time, the Committee are concerned at the capacity implications of accountability for, potentially, over 200 individual Foundation Trusts resting directly with Parliament.

2.1.1 The Government agrees it is vital that Parliament, and in particular the Public Accounts Committee, are clear about who to hold to account for health spending in the new system. The Government's plans for modernising the NHS are designed to improve overall accountability to Parliament, and strengthen Parliament's role over the NHS. Subject to approval by Parliament, the Health and Social Care Bill will ensure for the first time that roles and responsibilities across the whole of the NHS are clearly defined, leading to improved quality for patients and value for money for taxpayers.

2.1.2 Parliament, patients and the public will be able to see who is responsible for each aspect of the system, and this increased transparency will make it easier to hold those responsible to account. The functions of organisations will be set out in legislation by Parliament rather than left, as is largely the case now to the discretion of Ministers. The clear intention is to achieve a better balance between the roles of Parliament and the Executive in relation to determining structures and responsibilities within the NHS. Under the Bill, the role of Ministers in relation to the NHS will be far clearer.

2.1.3 Ministers will no longer be able to intervene in day-to-day operational decisions; front-line organisations will be directly responsible for the commissioning and provision of services. This is the culmination of a broad trend in reform by governments over the last 20 years to create more operational independence for the NHS, with the aim of making services more responsive to patients and driving up quality. Yet the Government's intention is clear – that such operational independence will be conducted within a firm framework of accountability, responsibility and transparency.

2.1.4 In the Government response to the NHS Future Forum report, the Government reiterated its commitment to the principle of overall Ministerial accountability. The Government has amended the Bill to make clear that the Secretary of State will continue to retain ultimate accountability for the health service. The Secretary of State will exercise this duty in three main ways.

2.1.5 First, the Department will set overall strategic policy and objectives for the NHS: in particular, by setting a mandate for the NHS Commissioning Board (NHSCB) outlining the objectives that it should seek to achieve using the budget it has been allocated. The NHSCB will have to report on how it has performed against the mandate, creating far greater transparency about what is delivered in return for taxpayers' funding than is the case at present.

2.1.6 Second, Ministers will oversee and hold to account the Department's arm's-length bodies (ALBs, of which the NHSCB is one), backed by an explicit duty to keep their performance under review. The Department will have powers to appoint the chair and appoint or approve the appointments of non-executive board members of ALBs. It will also have extensive powers of intervention in the event of significant failure.

2.1.7 Third, Ministers will continue to account for the health service: both to Parliament through Parliamentary Questions, debates and Select Committees, and through an annual report on the overall performance of the NHS. The annual report will be able to include an assessment of how effectively individual ALBs have performed their functions.

2.1.8 Although the direction of travel is towards a more autonomous system, the Secretary of State will have backstop powers in case they are needed, including: extensive powers of intervention in the event of significant failure; powers of direction over the entire system in the event of an emergency; and powers to direct national bodies if they fail to perform their functions.

2.1.9 Accounting Officers will continue to account to the Public Accounts Committee in the reformed NHS. The Department of Health Permanent Secretary and Principal Accounting Officer will be accountable to Parliament for the proper stewardship of the resources allocated to the Department. This includes the management of direct spending by the Department; gaining assurance on the performance of other bodies spending public money and the overall performance of the health system. The Chief Executives of all ALBs, including Monitor, the Care Quality Commission (CQC) and the NHSCB will be the Accounting Officers for their respective organisations. The responsibilities of an Accounting Officer are outlined in the Treasury guidance *Managing Public Money* (Chapter 3).

2.1.10 The Department expects to publish in the autumn a comprehensive statement describing the reformed system and the way in which the Permanent Secretary will discharge each of her responsibilities as Accounting Officer .

2.1.11 The Government believes that the new, devolved NHS will contain far stronger incentives to drive value for money and to ensure that services continue to improve and are responsive. There will be greater choice and voice for patients, and a new system for regulating providers in order to promote quality and efficiency.

2.1.12 The Government's reforms will also create greater scrutiny and transparency. In response to concerns from the Future Forum, the Department has strengthened arrangements to ensure that all the new organisations are sufficiently accountable to Parliament, patients and local communities for the decisions they make. For example, health and wellbeing boards will now play a greater role in the local commissioning process, working more closely with clinical commissioning groups (CCGs) as they develop their commissioning plans and having a say in the authorisation and assessment of CCGs. CCGs will be required to have a governing body which meets in public, to ensure that decisions about patient services and use of taxpayers' money are made in an open, transparent and accountable way. The Department has also amended the Bill so that all Foundation Trusts will be required to hold their board meetings in public.

2.1.13 The principal line of accountability for quality and efficiency of services (regardless of type of provider) will in future run through the commissioning side of the NHS, and this will be managed through the NHS Commissioning Board, CCGs will be accountable to the NHS Commissioning Board for the outcomes they deliver for patients and the stewardship of public resources.

2.1.14 Foundation Trusts, in recognition of their status as public bodies, whose spending ultimately counts towards the Department's budget, are subject to further accountability requirements. Foundation Trust Chief Executives are appointed as Accounting Officers for their organisation as set out in the NHS Act 2006. They are responsible for signing their own foundation trust's annual accounts, statement of internal control and annual report. They are therefore individually accountable for issues of probity, regularity, the management of resources against financial duties; the stewardship of assets, and for value for money.

2.1.15 A further change in response to the recent listening exercise is that the Department proposes to extend, until 2016, the transitional period during which Monitor will have specific powers to oversee Foundation Trusts, alongside its new role as regulator of all providers. The transitional powers will be reviewed in 2016 and could be extended further if necessary. During this period, Monitor will continue to be able to report on the Foundation Trust sector as a whole.

PAC CONCLUSION AND RECOMMENDATION 2.2

To what extent will health bodies having a 'duty to engage' locally with, for example: Health and Wellbeing Boards and Local HealthWatch, lead to accountability?

These are key mechanisms for communities to influence the shape of their local NHS services and need to be robust, with clearly articulated responsibilities, for the public and patients to have confidence that there is effective scrutiny over the quality and value for money of those services.

2.2.1 The NHS is funded out of national taxation and will continue to be primarily accountable nationally, to Parliament. But services must also be accountable more directly to patients and local communities. The Government's proposals will help achieve this: for example, by giving local councils far more influence, and strengthening the voice of patients and the public through HealthWatch. More generally, increased transparency and availability of published data on performance and outcomes will increase accountability across the system.

2.2.2 Local HealthWatch will play an important role in enabling people to help shape health and social care services at both a local and national level. It will provide a strong forum where the views and experiences of patients, carers and the public can influence the commissioning process and improve the quality of health and social care services. Local HealthWatch organisations will have stronger powers and responsibilities than their present equivalent (LINks). They will have stronger additional mechanisms to ensure local views are heard at national level through HealthWatch England. These arrangements will give local HealthWatch real clout in the system.

2.2.3 In response to the NHS Future Forum, the Department has strengthened the powers of local HealthWatch even further, building safeguards into the system to ensure that providers and commissioners, including those who manage and scrutinise local health and social care services, have regard to the views, reports and recommendations from local HealthWatch organisations. Local HealthWatch will be able to raise concerns on behalf of their local communities and the recipients of such reports will need to show that they have done what the duty obliges them to do, therefore holding those bodies to account.

2.2.4 The presence of local HealthWatch on the local health and wellbeing board will be another mechanism for public accountability, giving them a chance to feed patient views into strategic discussions. Where local HealthWatch have serious concerns, they have the ability to make recommendations to CQC to investigate local health bodies, either through HealthWatch England or, where the circumstances justify it, directly to CQC. Local HealthWatch can also raise concerns at a national level if necessary, through HealthWatch England to the Secretary of State or the NHSCB, who will be required to respond in writing to HealthWatch England.

2.2.5 Statutory health and wellbeing boards will be established in every upper tier local authority to improve health and care services, and the health and wellbeing of local people. Health and wellbeing boards will bring together locally elected councillors with the key commissioners in an area, including representatives of CCGs, directors of public health, children's services and adult social services, and a representative of local HealthWatch. Bringing these groups together represents a real opportunity to strengthen the democratic legitimacy of commissioning decisions, and provides a forum for challenge, discussion, and the involvement of local people.

2.2.6 Health and wellbeing boards will assess local needs (through the joint strategic needs assessment) and develop a shared strategy (in the form of a new joint health and wellbeing strategy) to address them, providing a strategic framework for commissioners' plans. These proposals significantly enhance the role of councils, ensuring they can play a leading role and strategically influence local NHS commissioning.

2.2.7 Following the Future Forum's report, the Department has further strengthened the role of health and wellbeing boards: giving them a greater role in promoting joint commissioning and integrated provision between health, public health and social care; requiring them to involve users and the public when preparing the joint strategic needs assessment and the joint health and wellbeing strategy; requiring CCGs to involve them in the development of commissioning plans; and requiring the NHSCB to seek the views of the shadow health and wellbeing board when authorising CCGs.

2.2.8 These proposals result in a shift of power to councils and the public, giving them an enhanced role in relation to the health and wellbeing of the local population. Greater strategic influence over the commissioning of health and social care services should help mean that services can better meet local needs. Alongside these changes the Department will also give local authorities greater discretion over how to exercise their health scrutiny powers, in line with the principles of the Localism Bill. In order to highlight the leadership role that local authorities play in scrutiny of health and social care, the Department will strengthen the current scrutiny powers by extending their scope to cover all providers and commissioners of NHS services.

PAC CONCLUSION AND RECOMMENDATION 2.3

What structures will link local GP consortia and the national NHS Commissioning Board, to which they are accountable?

The Commissioning Board will not be able to directly oversee several hundred GP consortia; what regional or other structures will be used and how will their cost-effectiveness be secured? Is one regional structure being abolished simply to be replaced by another one?

2.3.1 CCGs will be accountable to the NHS Commissioning Board for the outcomes they deliver for patients and their stewardship of public resources. Under the proposals in the Health and Social Care Bill, the NHSCB will take decisions about how best to discharge its responsibilities. Sir David Nicholson, Chief Executive-designate of the NHSCB, has set out some of his initial thinking on which of the organisation's functions should be carried out at a more local level in *Developing the NHS Commissioning Board*, published on 8 July 2011[3]. These include:

- Managing relationships with CCGs. This will be led by dedicated local teams of the NHSCB providing development support, monitoring finance and performance, measuring outcomes and providing information.

- Direct commissioning: this will be arranged at sub-national level and will include the management of contracts with primary care providers and commissioning of contracts for specialised services.

- Professional and clinical leadership, including links to local clinical networks to support and drive change.

- Managing local stakeholder relationships, for example, with local government, and HealthWatch.

2.3.2 Primary Care Trusts (PCTs) have been working together in 51 clusters. On 3 October 2011 Strategic Health Authorities (SHAs) will form into 4 clusters and it is likely that this framework will be reflected in the sub-national arrangements of the NHSCB, aligned as far as possible with the sub-national structure of other key national bodies. This approach will allow the transition to the new system to be phased and carefully managed, while also generating significant savings to support delivery of the productivity challenge. The nature and functions of the sub-national elements of the NHSCB will require significantly less capacity than PCT and SHA clusters.

2.3.3 The Department published a revised impact assessment, including an analysis of the costs and benefits of establishing the NHSCB, when the Bill was introduced to the House of Lords on 8 September.

[3] www.dh.gov.uk/en/Publicationsandstatistics/Publications/PublicationsPolicyAndGuidance/DH_128118

PAC CONCLUSION AND RECOMMENDATION 2.4

What information will be available to decision makers, the health regulators and the public on the cost and quality of services?

The Committee's reports have often been critical of the lack of robust information on the performance of health services; the Committee understands that the flow of information is to be rationalised and streamlined in the Health Information Strategy. The information must be relevant and fit for purpose, so that effective accountability can be secured.

2.4.1 Transparency and openness are key to ensuring accountability to the public, regulators and decision-makers. Those working on improving patient care need good quality information to know what high quality care looks like and track how services are improving. The Government's commitment to better information, more openness, transparency and comparability was highlighted in the consultation document *Liberating the NHS: An Information Revolution*.

2.4.2 The Department is now using the approximately 750 responses received to the consultation to develop its information strategy, which is expected to be published in the winter of 2011-12. As this is a vital and complex area, the Department has asked the NHS Future Forum to provide advice on how information can be made to improve health, care and wellbeing. The Forum will focus on information to empower patients; information to enable integrated care; how best to open up access to information and how best to encourage collection and use amongst professionals.

2.4.3 A variety of sources of information about quality are envisaged in the future. This includes information from the Outcomes Frameworks, including patient experience information and Patient Reported Outcome Measures (PROMs). The Prime Minister's letter, on 7 July 2011, on opening up data across Government, set out some key transparency commitments for the NHS such as publication of clinical audit data and patient complaints data.

2.4.4 A key source of data on the cost of health services is reference costs. These are published annually on the Department's website. The Department is working to improve the quality of reference cost information following a review and action plan developed in partnership with the Audit Commission. The Department has also been encouraging organisations to implement Patient Level Information and Costing Systems to help them better understand their underlying costs and in the long term drive up the quality of reference costs. Linking expenditure and health outcomes information is also important. As part of last year's publication of the NHS Atlas of Variation, health investment packs were produced for each PCT area comparing spend and outcome across programmes (disease groups). The Department is now working to develop this further for use by the NHS.

2.4.5 The Department agrees with the Committee that information must be relevant and fit for purpose. The Department's consultation on a Fundamental Review of Data Returns (launched 30 August 2011) aims to discontinue current data collections that are of limited value and that do not support NHS priorities, such as quality. The Department's aim is for the Health and Social Care Information Centre to become the focal point for health and adult social care information collections across England. The Department envisages that the Information Centre will play an important role in making data more readily available to the public, to information 'intermediaries' and to innovators who can exploit data for the benefit of health and social care services.

2.4.6 Subject to Parliamentary approval, the Secretary of State, the NHSCB, CQC, NICE and Monitor will have important roles in determining these information collections, including data about quality and costs. The NHSCB will have a central role to ensure strategies are streamlined and aligned. Others across the health and social care sector will be able to suggest information collections, in which case the Information Centre will generally have discretion as to whether to collect. In addition, the Information Centre will publish information in an anonymised form and will have a duty to minimise the burden it imposes on others.

PAC CONCLUSION AND RECOMMENDATION 3

There are a number of practical aspects of the proposed reforms which require clarification. This will help us to identify and focus our future hearings on the issues which present the greatest risks to value for money. The Department should lay out in detail the answers to the following questions:

PAC CONCLUSION AND RECOMMENDATION 3.1

How will the treatment of patients with rare and expensive conditions be funded?

To what extent will such conditions be funded through allocations to 'risk pools' rather than routine allocations to consortia and how disputes will be resolved?

3.1.1 Under the Health and Social Care Bill, the NHSCB will have responsibility for the direct commissioning of most specialised services for people with rare conditions. These services are currently commissioned either nationally (by the National Specialised Commissioning Team in London SHA) or regionally through the ten Specialised Commissioning Groups and on the basis of the services set out in the Specialised Services National Definition Set (SSNDS). The SSNDS will form the solid basis for the services the NHSCB will commission directly.

3.1.2 For these services, it will mean that the NHSCB will commission once, nationally instead of at least ten times, as currently. This presents the opportunity to ensure better planning, co-ordination and delivery of services in the future which will bring real benefits to patients with rare conditions.

3.1.3 Specialised services will be funded from within the overall resources available to the NHSCB. The details of the funding policy, including how it will work in practice, are currently being developed and further information will become available during 2012. The new arrangements will be in place by 2013 when, subject to Parliamentary approval, the NHSCB will take responsibility for commissioning these services on a national basis.

PAC CONCLUSION AND RECOMMENDATION 3.2

How will continuity of services be safeguarded when a GP consortium or Foundation Trust hospital is failing or has failed?

What roles will the NHS Commissioning Board, Monitor and the Care Quality Commission play and how will their actions be transparent to the local communities affected? Who will pick up liability for the debts of independent Foundation Trusts?

Provider failure

3.2.1 The Health and Social Care Bill provides for a 'continuity of services regime', which will secure continued access to essential NHS services and protect patients' interests where a provider of NHS-funded services is at risk or where a provider is unsustainable in its current form. The proposed regime builds on the regime established under the Health Act 2009; instead of repealing that legislation and applying insolvency law to NHS Foundation Trusts (as previously set out in the Bill).

3.2.2 Under the proposed arrangements, commissioners will remain responsible (as now) for securing services to meet the healthcare needs of their populations, including in the event of a provider of those services being at risk or becoming unsustainable in its current form.

3.2.3 Monitor's role will be to support commissioners in this, through: (i) proactive regulation of providers to assess and mitigate risk; (ii) intervention to support recovery where a provider is in 'distress'; and (iii) intervention to secure continuity of essential services in the event of a provider becoming unsustainable.

3.2.4 As a last resort, where intervention was unsuccessful and/or the organisation was fundamentally unviable in its current form, Monitor will trigger further intervention by appointing a suitably qualified person to take control of a provider's affairs and secure continuity of essential services.

3.2.5 Once the continuity of services regime has been triggered, the local commissioner will determine which services are essential, with input from the administrator and Monitor. Commissioners will also work with the administrator and agree proposals to secure continued access to these essential services, before consulting widely on them. If commissioners are unable to reach agreement, the NHS Commissioning Board will facilitate agreement and make a final decision if necessary.

3.2.6 The suitably qualified person will prepare a report to Monitor, recommending how to secure continued access to the essential services identified by the commissioners. The commissioners will be required to agree the report. The involvement of local communities is then secured through statutory public consultation with health and wellbeing boards, the public and other interested parties on the proposals before a final version of the report is submitted to Monitor.

3.2.7 Before Monitor decides what action to take in relation to the services, it will need to satisfy itself of the clinical case for any change. It will therefore receive an assessment by the Care Quality Commission of the provider's current service provision, to highlight any concerns over quality and patient safety.

3.2.8 The Secretary of State will have a right of veto over recommended solutions where he considers that the commissioners or the administrator has failed to discharge their functions adequately, either by:

- Failing to follow due process (in the case of the administrator); or
- Failing to secure continued access to services or to promote improvement in quality of care (in the case of by the NHSCB or relevant CCGs).

3.2.9 This power of veto would only be used in cases that have been locally disputed. It is expected that such a veto would only be used in exceptional circumstances.

3.2.10 In the unlikely event a Foundation Trust becomes unsustainable, it will be the responsibility of the administrator to look at all possibilities and negotiate to restructure any loans on more viable terms.

CQC

3.2.11 The role of CQC is to focus on the essential levels of safety and quality of care within providers. In the case of provider failure it will be the responsibility of CQC to take enforcement action where services fail to meet essential safety and quality requirements, including the possibility of fines and suspension of services.

Clinical commissioning group failure

3.2.13 Under the Government's proposals, the NHSCB will be able to intervene where there is failure, or a significant risk of failure by a CCG to carry out its statutory functions, although a failure in commissioning does not necessarily imply a risk of service failure. Service continuity would be ensured, as the NHSCB would be able to take on some or all of the CCG's commissioning responsibilities, or assign them to a third party, which could be another CCG.

3.2.14 The NHSCB will be able to provide support and resources to a struggling CCG. This could include direct remedial action, replacing an AO, varying a CCG's constitution, or – after consultation with those concerned and with relevant local authorities – dissolving a CCG and making other arrangements for the GP practices in that group. However, the Department envisages that this would be a last resort; there will be ongoing monitoring and dialogue to ensure CCGs are supported and able to improve and succeed. The triggers and procedures for intervention by the NHSCB will be transparent, and will operate on a sliding scale depending on the severity of the risks assessed in the CCGs. The NHSCB will communicate with local communities whenever it intervenes in the operation of a CCG, to ensure they are aware.

PAC CONCLUSION AND RECOMMENDATION 3.3

How will commissioners and providers contract with each other to drive value for money in the system?

There seem few incentives for GP consortia to drive better deals or for providers to offer prices below tariff. The Department has said that there will be no competition between providers on price, but there are concerns about what the Department means when it says that it wishes to see prices driven by the most efficient providers.

3.3.1 Value for money is about quality, not just price. The Government's proposals are based on a system of fixed prices, under which providers compete on quality of service, thereby driving up standards for patients at the same cost, improving value for money. More accurate pricing, reflecting best practice models of clinical service delivery, and efficiency in the provision of these services will make better use of NHS resources. A system of fixed prices will facilitate competition on quality and strengthen incentives for providers to improve. Improved efficiency in the use of NHS resources and improved quality of services will result in improvements in overall value for money.

3.3.2 When the Department states that it wishes to see prices driven by the most efficient providers this refers to the information Monitor and the NHSCB will use to set the national tariff for NHS-funded healthcare services. It is not about providers competing to undercut each other on price. The Department currently sets prices primarily based on average costs using information from all NHS providers. In the future, while it will be for Monitor and the NHSCB to decide how best to reimburse providers to promote quality and efficiency in line with their overall duties, the Government is keen to see them set prices on the basis of cost information from the most efficient providers.

3.3.3 The NHSCB's role in setting prices will be to determine the specification of the service required – for example: whether follow-up visits were included as part of the specification for a cataract service. Monitor will lead on developing methodologies for calculating the prices for NHS services and from those methodologies, calculating the actual prices to be paid. The Bill provides for consultation on the proposed tariff and that if there were a certain number of objections from clinical commissioners or providers, the proposed methodology for calculating prices would be referred to the Competition Commission for review.

3.3.4 Under the Government's proposals, prices will be fixed either nationally – through the tariff – or locally. For services that were not subject to the national tariff, local commissioners will set prices, in line with national rules. These rules will ensure optimal value for money for taxpayers. For example: for services subject to patient choice, national rules already say that prices must be fixed in advance of any competition. Patients, not commissioners, will decide which service to use. As patients will not pay for their care directly, competition will take place on the quality of service provided. Where services are not subject to choice nor covered by the national tariff it will remain an option for commissioners to decide to competitively tender in line with procurement law and guidance. Commissioners will award the contract to the provider offering the best value for money, taking both quality and price into account. This practice occurs currently for services not subject to national tariffs.

PAC CONCLUSION AND RECOMMENDATION 3.4

How will the NHS Commissioning Board work with GP consortia to redesign primary care services?

How will potential conflicts of interest between GPs' roles as commissioners and as providers of primary care be managed?

3.4.1 The NHSCB will be responsible for directly commissioning primary medical care services. However, the Bill is clear that CCGs will be required to support the NHSCB in achieving continuous improvement in primary medical care. This is to recognise the critical role of CCGs in the delivery of quality outcomes for the population they will serve – both in their capacity as commissioners and reflecting the role of their member practices as providers of and gatekeepers to NHS care.

3.4.2 Working through the local NHSCB staff, utilising the commissioning plans of CCGs and the health needs assessments undertaken by health and wellbeing boards, the NHSCB will seek to optimise the strengths and capacity of community based care and services to secure the greatest benefit and efficiency in the way services are delivered, for the local population, wider NHS and the taxpayer.

3.4.3 CCGs will not be directly responsible for commissioning the primary medical care services that GPs themselves provide. Nor will they commission the other family health services of dentistry, community pharmacy or primary ophthalmic services. These will be the responsibility of the NHSCB. There are three broad ways in which the new arrangements will manage conflicts of interest:

- statutory requirements on CCGs to have in place arrangements to manage conflicts of interest. These are part of the group constitution, and would be scrutinised by the NHSCB as part of the process of authorisation;

- requirements on each CCG to have a governing body, including two lay members, and a nurse and a doctor (from a provider which is not commissioned by the group). The governing body must oversee the arrangements for governance in the CCG; and

- power to make regulations requiring commissioners to follow good practice on procurement, to protect and promote the right of patients to make choices, and to manage any conflicts of interest between commissioning and providing services.

3.4.4 Monitor has various powers to investigate commissioning behaviour and if necessary, render a contract ineffective. The NHSCB could similarly intervene in a CCG if it were failing to meet its statutory duties to manage potential conflicts of interest.

PAC CONCLUSION AND RECOMMENDATION 3.5

How will the NHS Commissioning Board work with GP consortia to ensure the proper configuration of acute services so that value for money for the taxpayer and effective quality of healthcare for the patient is secured?

This is an issue of particular importance in urban centres where the NHS is presently seeking to redesign acute services.

3.5.1 A key aim of the Government's health reforms is to allow strategic decisions to be taken at the appropriate level. In a patient-led NHS, changes to services must be driven by what patients and local communities need. The proposals in the Bill will empower local organisations (CCGs) to develop services that best meet the needs of patients. CCGs will have the flexibility to collaborate with each other, health and wellbeing boards, and with the NHSCB in making decisions about the design and configuration of services. Commissioners will need also to work with provider organisations to enable them to plan for any changes.

3.5.2 Where commissioners require support in the planning and development of services, they will be able to obtain this from a range of sources, including the NHSCB. This includes support from clinical networks, which will advise on distinct areas of care such as cancer or maternity services, and from clinical senates, which will be able to offer a strategic clinical view on proposals for change. Clinical networks and clinical senates will be hosted by the NHSCB; they will not be organisations in their own right.

3.5.3 The NHSCB will also have a role in providing guidance and support for CCGs on achieving high quality, efficient services, and ensuring there is effective coordination between commissioners where there are service design issues that cross CCG boundaries. The library of Quality Standards that NICE will produce will inform the indicators in the Commissioning Outcomes Framework against which CCGs will be assessed. In this way, the NHSCB will provide support and incentives to enable CCGs to secure better value for money for patients and taxpayers within the resources available to them.

PAC CONCLUSION AND RECOMMENDATION 3.6

How will providers secure capital funding in future?

Capital funding may be provided by the private sector, either through PFI deals or through direct borrowing by trusts. These funding arrangements can be expensive, as recent reports by this Committee demonstrate. Will the Secretary of State ultimately underwrite these borrowing arrangements, and if so, how will the Department manage the residual risk it would bear should a trust be unable to meet its commitments? Who will manage the risk that some trusts reduce their capital spending too far in order to cut costs?

3.6.1 NHS providers currently finance capital investment through direct funding provided by the Department, through internally-generated surpluses, and through PFI schemes guaranteed by the Secretary of State for Health, through deeds of safeguard. Foundation Trusts and NHS Trusts also have powers to borrow directly from commercial banks or other lenders, however the Department is not aware of any significant private borrowing for capital projects.

3.6.2 Foundation Trusts and NHS Trusts will clearly need ongoing access to financing for investment in high quality services and the regime must support this. This will include ongoing access to public capital and the Department remains committed to providing this. Public capital should be provided through a transparent and rules-based system as would be required under the Health and Social Care Bill.

3.6.3 The Department will be required to publish detailed guidance on the terms and circumstances by which Government financing will be provided and an annual report setting out the detail of all such activity. This will provider greater clarity to Foundation Trusts, taxpayers and Parliament about the terms under which funding will be made available. The rules will need to balance the need for best value for the taxpayer and continued delivery of high quality services for patients. In addition, private finance initiatives (PFIs), or other arrangements whereby the private sector supplies funding direct to Foundation Trusts or their schemes, will continue to be options for investment in foundation trusts.

3.6.4 Specifically for PFI schemes, powers are retained in the Health and Social Care Bill to issue deeds of safeguard, where the Secretary of State contractually guarantees a Foundation Trust's payment obligations under a PFI scheme. The Department has been considering the circumstances under which a deed could be made available in future. This had to balance the need to obtain value for money in obtaining funding from the markets for PFI schemes and the desire to make NHS organisations as independent as possible from Government.

3.6.5 This process has been completed and it was announced on 28 July 2011 that deeds may still be issued subject to a PFI proposal having been approved by both the Department and the Treasury, on the basis of strict affordability and value for money tests. Full guidance on this will be published on the Department's website in due course.

3.6.6 In addition to PFI, Foundation Trusts have the power to borrow directly from commercial finance providers, and the Department will ensure that the new regime balances the need to ensure that Foundation Trusts do not borrow irresponsibly against the underpinning principle of freedoms for an autonomous provider sector.

3.6.7 NHS providers are responsible for deciding the level of capital investment required in order that their services meet the quality standards set by the NHSCB and the CQC. Should these quality standards not be met, then commissioners should work with providers to ensure that the provider addresses the issue. The CQC could also take regulatory action where significant quality issues occur as a result of lack of investment. In addition, Monitor's powers would allow it to impose licence conditions that required a minimum level of capital investment, but it would be a matter for Monitor to decide which licence conditions to develop.

PAC CONCLUSION AND RECOMMENDATION 3.7

How will legacy debts from Primary Care Trusts be handled?

The Department has indicated that GP commissioning consortia will not inherit Primary Care Trust debts, but accepts that it cannot guarantee this in all cases.

3.7.1 The Department expects PCTs and developing CCGs to work together to ensure financial control is maintained to prevent PCT deficits in 2011-12 and 2012-13. This will reduce the risk of CCGs having responsibility for any post 2010-11 PCT deficit uNetwork Railesolved at the point of PCT abolition.

PAC CONCLUSION AND RECOMMENDATION 3.8

How will the reforms affect existing health inequalities and performance variations for some NHS services?

The NHS currently has wide variations in the services patients receive in different parts of the country – for example, there is an eight-fold variation in the extent to which GPs refer their patients to cancer specialists. GPs' new role could help to reduce such variations, through more effective peer engagement. How will the Department and the NHS Commissioning Board monitor the effect of the reforms on service variation? What safeguards will there be against unacceptable variations in services in different parts of the country? How will the reforms drive a reduction in the present unacceptable health inequalities which exist?

3.8.1 The Government believes the reforms set out in the Health and Social Care Bill will deliver better outcomes for all patients through improving the quality, efficiency and fairness of services and by reducing health inequalities. The Bill clarifies accountability for quality, for the first time creating explicit duties on the Secretary of State and on NHS commissioners around securing continuous quality improvements in health outcomes and care quality, and tackling health inequalities.

3.8.2 The NHS Outcomes Framework provides a high-level overview of how the NHS is performing against a balanced set of outcome measures. As part of this, the Department is exploring to what extent data can be disaggregated to monitor trends in inequalities. The Framework will, through the Mandate, provide a key accountability mechanism between the Secretary of State and the NHSCB. In setting the Mandate, the Secretary of State will have the option to set levels of ambition for the NHSCB which could include specifying a reduction in health inequalities. Regardless of the specific levels of ambition set, many of the indicators within the Outcomes Framework – such as reducing mortality from liver disease in the under-75s – will not be improved without tackling inequalities in access to services, in prevention and in the wider determinants of health.

3.8.3 The Bill gives CCGs a legal duty to support the NHSCB in continuously improving the quality of primary care. If the NHSCB decides to delegate the function, this could include supporting practices to reduce health inequalities and performance variations.

3.8.4 The NHSCB will decide how best to deliver improvements on the ground and translate the national outcomes into outcomes and indicators that are meaningful at a local level in the Commissioning Outcomes Framework against which clinical CCGs will be held to account. The Commissioning Outcomes Framework could test how CCGs are fulfilling their statutory responsibility to support the NHSCB in driving up the quality of primary medical care or capture outcomes that are achieved through a combination of good provision of GP services and good commissioning of wider healthcare services. This, together with tools such as the NHS Atlas of Variation[4], along with continued reform to general practitioners' contractual arrangements to better address health outcomes and inequalities in provision, provide opportunities for the commissioning system to monitor and address variations in performance.

[4] The NHS Atlas of Variation, published November 2010 (http://www.rightcare.nhs.uk/atlas/) brings together data on clinical spend and links this with the health outcomes patients see.

3.8.5 Ultimately, as emphasised by the NHS Future Forum, the fact that GPs, through the development of CCGs, will be responsible for their local populations, as opposed to just their patient lists, means that they will need to take into consideration the broader impact, and therefore their duty to reduce inequalities, of their clinical decisions. In addition, the strengthened role of health and wellbeing boards means local commissioners will be required to give an account if their commissioning plans are not in line with the joint health and well-being strategy, which is informed by the joint strategic needs assessment.

3.8.6 Some variation is justifiable in healthcare and the NHS – for example, where the NHS tailors services to appropriately meet the clinical needs of local populations. However, not all variation can be appropriately justified by different population needs and circumstances. Therefore, in addition to the legally protected characteristics, the Department is considering disaggregating its data by socio-economic and area deprivation, both of which are drivers of poor health outcomes. The NHS Outcomes Framework provides a safeguard against unacceptable variations. The overall quality framework, including NICE Quality Standards, provides the tools to support commissioners in achieving these outcomes.

3.8.7 From 2013-14 ring-fenced public health grants, targeted for health inequalities will be made to upper-tier and unitary local authorities for improving the health and wellbeing of local populations. The Department is developing a health premium which will reward local authorities for the improvements made against a subset of the outcomes in the public health outcomes framework, and incentivise action to reduce health inequalities. Further detail on the allocations and health premium will be announced in due course. The Department is also developing a public health outcomes framework and the Department's aim is to develop indicators that can be analysed on the basis of their differential impact on different groups in society.

PAC CONCLUSION AND RECOMMENDATION 4

The Department acknowledges that it may not be able to achieve all the savings intended under its efficiency programme.

The Department said that 40% of the savings were controlled nationally, through pay freezes, central budgets and management cost savings, and it was confident it could deliver these. A further 40% would come from efficiency gains in providers, delivered through setting the tariff. The final 20% would be due to service change such as shifting services from hospitals into the community and these would be the most difficult to achieve. The Department needs to monitor the savings and report regularly on progress against the target.

4.1 The Government agrees with the Committee's recommendation, and savings made by the NHS will be monitored quarterly. The Department will compare these savings against plan, and report these forecast savings to assess progress against the target. The Department also intends to collect data on the actual savings later in the year, which will also be reported through the processes the Department has put in place to report on the Integrated Performance Measures, as outlined below.

4.2 The Integrated Performance Measures, covering quality, resources and reform measures, as laid out in the Operating Framework for 2011-12 are the measures the Department will use to ensure that the NHS is on track to deliver the QIPP challenge whilst at least maintaining quality. These will be published regularly in "The Quarter", the quarterly update available on the Department's website, outlining the NHS financial position alongside progress made in health and health services.

PAC CONCLUSION AND RECOMMENDATION 5

The Department's estimates of transition costs rely on GP commissioners being ready to take on a certain proportion of former Primary Care Trust staff.

The Department has no control over such decisions or the resultant redundancy costs. The Department needs to regularly review the emerging costs of the transition and have contingency arrangements in place if costs exceed expectation. The Committee will monitor the progress and costs of the reforms, beginning later in 2011.

5.1 The Government agrees with the Committee's recommendation. The Government recognises this risk and has been preparing mitigating actions so that costs are managed and constrained.

5.2 The Department has a range of practical actions to help manage these risks. These include:

- developing a comprehensive suite of HR Frameworks and policies to provide the over-arching guiding standards relating to the movement of employees to the new and changed bodies being proposed in the Health and Social Care Bill 2011;
- minimising the difference between the geographical distribution of the old and new systems;
- assessing the scope to transfer some of this risk to those most able to manage it, for example by providing local incentives to minimise redundancy costs; and
- providing clear messaging around the priority to minimise costs.

5.3 The estimated costs of the transition have fallen from £1.4 billion to £1.2 - £1.3 billion. This is as a result of assumptions being refined, as more information becomes available about how the modernisation is being implemented locally. The Department is continuing to monitor the costs associated with the modernisation. More information about this is included in the revised impact assessments, which were published on 8 September 2011.

5.4 The Department continues to monitor the costs of transition and is very mindful of the need to live within the Spending Review settlement, and to ensure the best use of funds so that maximum resources are provided to front line services. The range of policy options and monitoring arrangements will enable the Department to mitigate and identify any potential cost escalation, so that appropriate action can be taken, including reprioritising activity. More detail about precisely how this will be done will be released in due course.

PAC CONCLUSION AND RECOMMENDATION 6

The Department told the Committee that there are at least 20 NHS hospital trusts which will struggle to obtain Foundation Trust status.

The Provider Development Authority will have the responsibility to bring them up to the required standard but this will be particularly challenging where hospitals are burdened with significant PFI or other debts. The Department should set out its contingency arrangements to ensure the supply of services in areas where trusts cannot meet the criteria to become Foundation Trusts. This should include clarifying the roles of Monitor and the Care Quality Commission in such cases. The Department will need to make arrangements for handling PFI debt in a way that allows all Foundation Trusts to operate on equal terms in the marketplace.

6.1 The Government agrees with the Committee's recommendation.

6.2 In the Government's response to the Future Forum's report, the Department made clear that it expects the majority of remaining NHS trusts to be authorised as Foundation Trusts by April 2014. The

NHS Trust Development Authority will support this process and maintain the momentum, which will be essential for overall delivery. It will not be an option to stay as an NHS trust, but there will no longer be a blanket deadline in the Bill for abolishing NHS trusts as legal entities. The stringent tests set by Monitor will remain, and Monitor will continue to obtain assurance from CQC as part of the authorisation process.

6.3 A programme of regional support and national coordination and leadership of policy issues for NHS trusts is being developed to provide them with the necessary assistance to enable a successful Foundation Trust application and maintain clinical quality and service provision whilst on their journey to Foundation Trust status. The key challenges trusts may face include, lack of a clear clinical strategy, financial issues, leadership capacity and capability and / or underlying performance issues.

6.4 As mentioned above, to enable time for Foundation Trust governors to build capability in holding their boards to account, the Department will further extend, to 2016, the transitional period where Monitor retains specific oversight powers over Foundation Trusts. Monitor's oversight will last until two years after a Foundation Trust is authorised, if that is later. To provide continuity during a challenging period, and in recognition of concerns about the readiness of Foundation Trust governors, these powers will initially apply to all Foundation Trusts, and they will be reviewed in 2016.

6.5 A review is currently underway looking into the PFI schemes of 22 NHS trusts across the country. A report with recommendations for next steps will be published shortly.

PAC CONCLUSION AND RECOMMENDATION 7

The small size of some GP consortia risks creating inefficiencies in the system.

Currently there are pathfinder consortia with as few as 14,000 patients. Very small consortia may lack commissioning expertise and influence over providers, affecting their ability to secure the highest quality services for their patients. They may also have disproportionately high overheads. There is a risk that the funding of £35 per head for the running costs of GP consortia may allow small consortia the scope to be inefficient whilst larger consortia are overfunded for their running costs. The flat rate charge may also lead to some consortia trying to 'game' the system.

The Committee will take a close interest in the efficiency of the system in this regard and the Department should take steps to ensure that the level of administrative funding for consortia of different sizes is adequate but not generous, and does not introduce perverse incentives.

7.1 The Government agrees with the Committee's recommendation.

7.2 The NHSCB will be responsible for making allocations, including running cost funding, to CCGs, in line with the needs of their populations. CCGs of different sizes will be expected to identify the most efficient ways for them to deliver their functions, which may include sharing services and overheads where appropriate. Clearly, the process of making allocations will need to consider the appropriate rate for funding CCGs, to ensure best value for the taxpayer. Both the NHSCB and CCGs will be under a statutory obligation to exercise their functions effectively, efficiently and economically, and bound by specific statutory duties relating to financial control, including a duty to ensure expenditure on administration does not exceed a set amount.

7.3 The NHSCB will be responsible for ensuring that CCGs are of sufficient size to manage financial risk and to allow for accurate allocations. The Department does not wish to be unduly prescriptive about the size of CCGs. There have been widespread variations in the size and population coverage of PCTs, and there is no evidence to suggest a single 'right' size. It is important that solutions are developed from the bottom up and are not imposed from above, so the Department is working with the pathfinders to ensure that prospective CCGs are appropriate to meet the needs of their intended population, and are the right size to carry out their functions, either alone, or in constructive partnership with neighbouring CCGs where appropriate.

PAC CONCLUSION AND RECOMMENDATION 8

Given the pace of change, there is a risk that there is insufficient time to learn the lessons emerging from the new model, for example how the NHS Commissioning Board will organise itself to oversee and support consortia of potentially widely varying sizes.

The NHS Commissioning Board will be formally established in April 2012, which will provide limited time for it to learn the lessons of the GP pathfinder consortia, for example, at what scale efficient commissioning decisions should be made for different services. The Committee will expect to see the proposals refined where appropriate to respond to lessons arising from the pathfinders. The Department should set out in detail how and when it will appraise the pathfinder consortia and when those results will be made public.

8.1 The Government agrees with the Committee's recommendation.

8.2 To be clear the NHSCB will be established in shadow form by October 2011 as a special health authority. By October 2012, subject to Parliamentary approval for the Bill, the NHSCB will be established formally as a non-departmental public body, and will start to authorise CCGs. But it will only take on its full responsibilities from April 2013. Pathfinder experience will inform the shadow NHSCB of key factors it will need to address in the support it provides to CCGs during 2012-13 and will influence the policies that define the future NHSCB.

8.3 The Government recognised that there were concerns about the pace of the Department's modernisation plans. In response to the Future Forum's concerns that some organisations may not be ready to take on their full responsibilities at exactly the same time, the Department has introduced more flexibility to the modernisation timetable:

- As previously proposed, PCTs will cease to exist in April 2013. However, CCGs will not be authorised to take on any part of the commissioning budget in their local area until they are ready to do so;
- by April 2013, GP practices will be members of either an authorised CCG, or a 'shadow' commissioning group, i.e. one that is legally established but operating only in shadow form;
- where a CCG is ready, it will be able to take on commissioning responsibility earlier. Where a group is not yet ready, the local arms of the NHSCB will commission on its behalf;
- preparations for the NHSCB will begin in autumn 2011 and it will be established by October 2012 so that it can start to authorise CCGs. The NHSCB will only take on its full responsibilities from April 2013;
- choice of Any Qualified Provider will be phased in gradually from April 2012;
- the Department's expectation is that the remaining NHS trusts will be authorised as FTs by April 2014. But if any trust is not ready by then, it will continue to work towards Foundation Trust status under new management arrangements. The Department will further extend, to 2016, the transitional period where Monitor retains specific oversight powers over Foundation Trusts; and
- The Department will ensure a safe and robust transition for the education and training system, and will set out further details in the autumn.

8.3 The revised modernisation timetable allows for greater input from pathfinders, ensuring their experiences and lessons learned help to shape the development of the future health and care system.

8.4 The Government has created the 'Pathfinder Learning Network'[5] which offers the opportunity for dialogue with participants in the pathfinder programme. The Department runs bespoke national learning events for pathfinders, which include workshops where policy issues are discussed and participants' opinions are canvassed.

8.5 The Government recognises the need for a formal appraisal of the pathfinder experience. The Department has commissioned the London School of Hygiene and Tropical Medicine and the University of Manchester to lead on a detailed, independent evaluation of the pathfinder programme. Initial findings are expected around December 2011. A more detailed report on the pathfinder experience (evaluation with lessons learned) is expected around June 2012.

8.6 Pathfinders were invited to input into the development of the authorisation framework for prospective CCGs at national learning events in May and June 2011, and will have an opportunity to comment and feedback on the first iteration of the authorisation framework when it is shared with the NHS and key stakeholders (expected early August 2011).

[5] http://healthandcare.dh.gov.uk/category/pathfinder-learning-network

Thirty Eighth Report

HM Treasury (HMT)

The impact of the 2007-08 changes to public service pensions

Report Summary from the Committee

In 2007-08, new pension schemes were introduced for civil servants, NHS staff and teachers. The changes were in response to Treasury requirements for savings in taxpayer costs to make public service pensions affordable.

Three main changes were made. First, the age at which a scheme member could draw a full pension was increased from 60 to 65 years for new members. Second, employee contributions were increased by 0.4% of pay for teachers and by up to 2.5% of pay for NHS staff. Third, a new cost sharing and capping mechanism was introduced to transfer, from employers to employees, extra costs that arise if pensioners live longer than previously expected. The Coalition Government announced additional changes in 2010, including indexing pensions to the Consumer Prices Index rather than the Retail Prices Index, which are expected to reduce costs further.

Government projections suggest that the 2007-08 changes are likely to reduce costs to taxpayers of the pension schemes by £67 billion over 50 years, with costs stabilising at around 1% of Gross Domestic Product (GDP) or 2% of public expenditure. This would be a significant achievement. The Committee would, however, encourage the Treasury to publish a clear measure or benchmark of affordability which indicates the level of spending on public service pensions it considers sustainable. Officials appeared to define affordability on the basis of public perception rather than judgement on the cost in relation to either GDP or total public spending.

The Committee are concerned that the Treasury did not test the potential impact of changes in some of the key assumptions underpinning the long-term cost projections. These include assumptions about the rate of growth in GDP, the size of the public service workforce, and the wider impact of the 2007-08 changes on increased payments in means-tested benefits and reduced receipts from taxation and national insurance. In addition, the Treasury has not tested whether reducing the value of pensions would affect the public sector's ability to recruit and retain high quality staff.

The Committee heard concerns that the discount rate used to set pension contribution levels was too high. A lower discount rate leads to higher contributions from employees and employers, reducing the long-term cost of pension schemes to taxpayers. Following a Treasury review including a public consultation, the Government has now set a new, lower discount rate which was announced in the 2011 Budget. This has removed uncertainty about the appropriate level of the discount rate.

Three-fifths of the savings to the taxpayer were expected to come from the cost sharing and capping mechanism. Under this mechanism, employees would bear a greater share of costs, potentially paying 70% more for their pensions over the next 50 years if life expectancy continues to increase more than expected. However, implementation of the mechanism has been deferred, initially because of the Treasury's discount rate review. Implementation remains on hold while the Government decides how to respond to the Independent Public Service Pensions Commission (the Hutton Commission), which has recommended that cost sharing and capping be developed into a 'cost ceiling' that sets an upper limit on the amount the Government contributes to employees' pensions. An early decision to implement cost sharing and capping is important for providing certainty to both employees and employers.

Pensions form a substantial share of the total salary package received by public service employees. The Committee was concerned that employees do not have a clear understanding of the value of their pensions because they are not provided with clear and intelligible information to enable them to make rational decisions. This may mean the benefits of public service employment are not fully appreciated by current and prospective employees, potentially diminishing the influence of pensions as a recruitment and retention tool.

Public service pensions policy is not joined up with planning in other areas of public policy and spending. Whilst this is not a new issue, the Committee still found it concerning given the potential impact that pension changes could have on areas such as future demand for means-tested benefits. There is little evidence to judge whether wider pension policy measures are effective, including measures such as tax relief and other incentives to encourage people to save for their retirement.

Further changes to public service pensions are expected in the near future. In the 2011 Budget, the Government announced that it had accepted the Hutton Commission's recommendations for long-term structural reform of public service pensions as the basis for consultation with public sector workers, unions and other interested parties. Following this consultation, it will set out proposals in autumn 2011. This provides the opportunity for the Government to develop a clear strategic direction for public service pensions. The Committee looks forward to the Government's detailed proposals and, following their implementation, a period of much-needed stability and certainty for long-term public service pensions policy.

The Committee took evidence on two reports from the Comptroller and Auditor General, looking at the cost of public service pensions and the impact of the 2007-08 changes.

Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 1

Government projections show that the expected cost of public service pensions has reduced substantially because of changes made in 2007 and 2008.

The Treasury expects the cost of pension payments to retired civil servants, NHS staff and teachers to stabilise over the next 50 years at around 1% of GDP, as a result of the 2007-08 changes. This would be a significant achievement. The exact range of savings is unclear because sensitivity analyses were not conducted on significant areas of uncertainty such as the size of the public service workforce. The Treasury acknowledged the need for more robust analysis in future, and the Committee welcomes its commitment to carry out deeper sensitivity analysis when considering further pension changes.

1.1 The Government agrees with the Committee's conclusion.

1.2 Projections of expenditure on public service pensions over the next fifty years are inherently uncertain. Sensitivity analysis can assist in understanding the extent of uncertainties and risks.

1.3 The most recent assessment of the long-term costs of pension payments to public service pensioners was published by the independent Office for Budget Responsibility (OBR) on 13 July 2011, as part of their *Fiscal Sustainability Report*[6]. The Report estimated that public service pensions would fall from 2.0% of GDP in 2010-11 to 1.4% of GDP by 2060-61.

1.4 These projections take into account the recent switch from the Retail Prices Index to the Consumer Prices Index for the up-rating of pensions in payment, which was not part of the 2007-8 changes to public service pensions, but introduced by this Government. However, the projections excluded the effects of the previous Government's cap and share policy, as no firm proposals for reforms to implement these had been made at the time of publication. These projections include expenditure for all the unfunded public service pension schemes as well as analysis of the sensitivity of the projections to longevity changes, earnings growth and workforce size assumptions, as recommended by the Committee.

1.5 Changes to date, such as the switch from the Retail Prices Index to the Consumer Prices Index for the up-rating of pensions in payment, have had a significant impact on the cost of public service pensions. However, in the Independent Public Service Pensions Commission's interim and final reports, Lord Hutton was clear that these reforms alone did not go far enough. He said that "the status quo is not tenable', 'future costs are inherently uncertain' and the public 'cannot be sure that schemes will remain sustainable in the future'. As people live longer it is unfair to ask the taxpayer to work longer and pay more for public servants to receive more.

1.6 The OBR expects to publish such assessments annually, and to publish forecasts of expenditure up to five years ahead biannually.

[6] http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2011/

PAC CONCLUSION AND RECOMMENDATION 2

Uncertainty about the discount rate used to set pension contribution levels has in the past undermined confidence about how future costs of pensions are valued.

The discount rate is used to determine the annual levels of employer and employee contributions to pension schemes. A lower discount rate leads to higher contributions from employees and employers, reducing the long-term cost of pension schemes to taxpayers. The Treasury told the Committee that the existing discount rate was too high and, following a public consultation, the Government set a lower rate. At the same time the Government committed to reviewing the discount rate every five years. In order to maintain certainty for both employees and employers in the future, the Committee expect these reviews to be conducted promptly and transparently.

2.1 The Government agrees with the Committee's conclusion.

2.2 Lord Hutton concluded in the interim report of the Independent Public Service Pensions Commission[7] that the current discount rate used to set contribution rates in the public service schemes was at the high end of what is appropriate and should be reviewed.

2.3 In response to Lord Hutton's recommendation, the Government launched a full public consultation on 9 December 2010. The consultation closed on 3 March 2011. A number of roundtable stakeholder events were held and all responses were carefully considered before next steps were determined.

2.4 The Government published a summary of responses to the consultation on the discount rate[8] on 5 April 2011. The Government concluded that a rate based on expected long-term Gross Domestic Product (GDP) growth best meets the purposes and objectives identified for the discount rate, and provides both a theoretically sound and practical methodology for setting the rate. A discount rate of three per cent per annum plus CPI will be adopted for future valuations.

2.5 Balancing the need for stability with the attraction of reviewing the discount rate periodically, the Government proposes to review the level of the discount rate every five years and the methodology every ten years. The Government may also review the discount rate "out-of-cycle" in the event of a significant change in circumstances.

PAC CONCLUSION AND RECOMMENDATIONS 3 AND 4

Cost sharing and capping is the change intended to deliver 60% of the projected cost savings over the next 50 years, but it is not yet clear when it will be implemented or in what form.

The delay so far in implementing cost sharing and capping is largely due to the time taken to revise the discount rate. Additional uncertainty has arisen from the Hutton Commission's recommendation to replace cost sharing and capping with a cost ceiling that fixes an upper limit on the amount the Government contributes to employees' pensions. The Government will consult on the Hutton recommendations before setting out its proposals for further change in autumn 2011. As soon as possible following the consultation, the Treasury should publish its timetable for implementing cost sharing and capping or an alternative scheme, as well as the expected cost savings.

There is no measure defining an affordable level of expenditure on public service pensions, against which actual costs can be compared.

The Treasury reports on public service pension costs as a proportion of GDP, but has no criteria by which to judge their affordability. The Treasury should set out what it believes is an affordable level of spending so it can assess the cost of public service pensions against a clear benchmark.

[7] http://www.hm-treasury.gov.uk/d/hutton_pensionsinterim_071010.pdf
[8] http://www.hm-treasury.gov.uk/d/consult_discount_rate_summary_responses.pdf

3.1 The Government agrees with the Committee's recommendations.

3.2 In his interim report, Lord Hutton said of cap and share: "*these reforms have not fully addressed the underlying issues of sustainability and fairness... Cap and share cannot take account of the increases in cost of pensions over recent decades because people have been living longer*".

3.3 Lord Hutton recommended that the Government, on behalf of the taxpayer, should set out a fixed cost cap that is *"the proportion of pensionable pay that they will contribute, on average, to employees' pensions over the long term."* The Government has accepted this recommendation as a basis for consultation.

3.4 The Government believes that there should be a cost ceiling mechanism to ensure that public service pensions are introduced on an affordable and sustainable basis. The Government will set out more detailed proposals in due course. Once these cost ceilings are set, they will guide each public service pension scheme's discussion on the design of their future scheme.

3.5 Once scheme design is agreed, the Government will put forward proposals to place a 'cost cap' on the employer contribution to public service pensions. This will build on and replace the concept of "capping" under the cap and share proposals.

3.6 The Government expects the OBR to publish an assessment of any expected cost savings in future *Fiscal Sustainability Reports.*

PAC CONCLUSION AND RECOMMENDATION 5

Employees are not given the information they need to understand the value of their pensions.

This hinders their ability to make rational decisions about important matters such as alternative employment options or whether to stay in, or opt out of, a pension scheme. Public service employers should make clear to prospective and existing employees the financial value a pension adds to their salary package. The Treasury should work with employers and pension schemes to ensure clear and relevant information is provided to employees on the value of their pensions, and that this information is regularly updated and its usefulness to staff assessed.

5.1 The Government agrees with the Committee's recommendation.

5.2 In his final report, Lord Hutton recommended that "*all public service pension schemes should issue regular benefit statements to active scheme members, at least annually and without being requested and promote the use of information technology for providing information to members and employers*".

5.3 The Government is committed to developing principles on best practice in scheme governance and administration, including in the provision of information to employees on the value of their pensions. The Government will be discussing these principles with the Trades Union Congress (TUC) and other representative bodies, and more widely on the appropriate standards for transparency and consistency across all areas of scheme administration and governance.

PAC CONCLUSION AND RECOMMENDATION 6

It is not clear whether wider measures to encourage pension saving through occupational schemes are effective.

The UK's pension model has traditionally relied on strong occupational pensions to supplement the state pension. However, the progressive decline in the number and value of occupational pension schemes, particularly in the private sector, means that many people are not saving enough for their retirement. The Treasury encourages pension saving through occupational and other schemes by spending substantial sums of money on tax relief and reductions in national insurance contributions, but has not explained whether these measures are cost-effective and well-targeted. The Treasury should clearly set out the costs and benefits of each measure of pension support, who benefits from each form of support, and how it judges the success of each measure.

6.1 The Government agrees with the Committee's recommendation as set out below.

6.2 Although occupational pension provision has declined slightly over the last decade, it remains an important source of additional retirement income for individuals. The Annual Survey of Hours and Earnings (ASHE) estimates that 50% of UK employees were members of an employer-sponsored pension scheme in 2009, down from 55% in 1997. The Government acknowledges the importance of increasing workplace saving, and committed in 2010 to introducing automatic eNetwork Railolment from October 2012. This places a duty on all employers to automatically eNetwork Railol eligible jobholders into a qualifying workplace pension scheme, and is expected to result in 5-8 million individuals starting to save or saving more in a workplace pension scheme.

6.4 HM Revenue and Customs (HMRC) publish annual statistics on pensions tax relief on their website. In 2009-10, pensions tax relief cost £28.1 billion, while £8.4 billion in tax on pensions income was received, and so the net cost of tax relief was £19.7 billion. National Insurance relief for employers cost a further £8.3 billion. However, these figures do not account for the difference between cohorts of savers, since the current recipients of tax relief will later pay tax on their pension income. The Government has recently taken action to restrict pensions tax relief for the highest contributors, which will reduce the cost of pensions tax relief by approximately £4 billion per year in steady state, and help ensure that tax relief remains affordable and sustainable in the long term.

6.5 Assessing the behavioural impact of tax incentives, and so their effectiveness, is inherently difficult. However, the recent independent Mirrlees Review of UK taxation endorsed the UK's 'EET' (Exempt, Exempt, Taxed) pensions tax regime as an appropriate way in which to tax pension savings. The Pensions Commission report in 2005 also noted that tax and National Insurance relief significantly improved employers' incentives to remunerate employees through pension contributions. The Government will monitor and evaluate the effects of the reforms to pensions tax relief and the introduction of automatic eNetwork Railolment from 2012, in line with the objectives of increasing pension saving and ensuring pensions tax relief remains affordable and sustainable.

PAC CONCLUSION AND RECOMMENDATION 7

Changes to public service pensions affect other areas of public spending, such as means-tested benefits, but not all of these impacts have been identified and assessed.

For example, increasing the amount that employees have to contribute to pension schemes could result in more people opting out of their pensions and having to rely on means-tested benefits, leading to extra costs to the public purse. Important implications of this kind need to be evaluated and understood. In particular, the Treasury should ensure that decisions to change public service pensions take into account the potential impact on spending on means-tested benefits.

7.1. The Government partially agrees with the Committee's recommendation that the Treasury should take into account the potential impact on means-tested benefits, however the Treasury considers that the impact will be minimal.

7.2 The Government will consider the implications of pension reform for scheme membership when bringing forward final proposals. The Government has said that the pensions low and middle earners receive, when they retire, will be broadly as generous as they are now.

7.3 The Government has committed that member contribution rate increases will be structured to protect those on the lowest incomes to minimise the risk of employees opting out of their pension. Any employee who opts out of their public service pension scheme is likely to contract back into the State Second Pension. This means the employee will pay more National Insurance but in return will receive a higher State Pension when they reach State Pension Age.

7.4 Budget 2011 announced the Government will look to reform the State Pension for future pensioners so that it provides simple, contributory, flat-rate support above the level of the means-tested Guarantee Credit.

7.5 This implies that there is likely to be little or no upwards pressure on demand for means-tested benefits.

PAC CONCLUSION AND RECOMMENDATION 8

Further reforms expected in the near future present the opportunity for the Government to determine a stable, long-term direction for public service pensions.

The Treasury announced in the 2011 Budget that it will propose further changes to public service pensions once it has consulted public sector workers, unions and others on the Hutton Commission's recommendations. The Treasury should set out clear objectives for any further changes, develop consensus around those changes and put in place arrangements to monitor progress. It should then aim for a period of stability so that employees' confidence in the value of their pensions is not undermined by fears that further changes will be made.

8.1. The Government agrees with the Committee's recommendation.

8.2 The Government has set out its intention to reform pensions so that they are "*affordable, sustainable and fair to both the public sector workforce and the taxpayer*". The Chief Secretary to the Treasury has said that public service pensions reform should ensure "*that the costs of providing pensions to our workforce are affordable, not just now...but in the decades to come*"[9]. If pensions are reformed effectively now, to adapt to changes such as longevity before the situation worsens, the Government will be able to implement high-quality pension arrangements that are fair and stable.

8.3 The Government has had a series of constructive discussion with trades unions covering Lord Hutton's key recommendations. Discussions will now take place at scheme-level alongside continuing central discussion to make progress on reform. Scheme level discussions will ensure a fuller understanding of the implications of reforms, before final conclusions are reached.

8.4 This will protect public service pension provision for the long term, and secure for the next generation of public servants defined benefit pension schemes that will be amongst the very best available.

[9] Chief Secretary speech to the IPPR, 17 June 2011: http://www.hm-treasury.gov.uk/press_61_11.htm

Thirty Ninth Report

Department for Transport (DFT)

The InterCity East Coast passenger rail franchise

Report Summary from the Committee

Since the mid 1990s, passenger rail services have been delivered through a system of franchises. Each franchise is a competitively procured contract, typically lasting seven to ten years, between the Department for Transport and a private train operating company. Companies bid for franchises on the basis of the amount of subsidy they require, or the premium they would be prepared to pay, to run services on a defined part of the rail network. Bids include each company's forecast of what revenue they can expect, based on assumptions about the number and type of passenger journeys and the prices they can charge.

The InterCity East Coast Mainline is a hugely significant rail service, carrying around 19 million passengers a year between London, the North East and Scotland. The franchise has had a troubled history. In 2005, a contract was awarded to Great North Eastern Railway, but financial difficulties at its holding company meant that the franchise failed 18 months later.

In 2007, a new contract was awarded to National Express to run the franchise on the basis that it would pay the Department £1.4 billion over seven and a half years. At the time, the East Coast franchise was one of three operated by National Express, which also ran passenger services in the South East and East Anglia. As a result of the economic downturn, expected passenger revenues did not materialise and National Express announced in July 2009 that it wanted to opt out of the contract and would not provide the necessary financial support to the East Coast franchise.

Following negotiations with National Express, the Department terminated the contract in November 2009 and transferred services to a new publicly owned company, Directly Operated Railways, until the franchise could be re-tendered. Although other franchises suffered financial difficulties during the economic downturn, East Coast was the only franchise that failed.

In negotiations, the Department turned down an offer worth £150 million from National Express to exit the franchise by mutual consent. Instead the Department chose to terminate the contract, and received £120 million from National Express. The Department judged that foregoing the extra cash would reduce the risk of other train operating companies with loss-making franchises seeking similar deals, but the taxpayer did forfeit £30 million. The Department allowed National Express to keep its two other franchises, and in December 2010 told National Express that the termination would not be held against the company if it bid for future franchises.

Since the East Coast termination, other franchises have been in financial difficulty and their holding companies have not sought to hand them back. The Committee is, however, concerned that the Department created a moral hazard by allowing National Express to pay a lesser financial penalty through terminating a contract than it would have done by paying £150 million to exit consensually, and by choosing not to hold the termination against National Express in future bids.

The Department has potentially incentivised other holding companies with loss-making franchises to terminate, rather than renegotiate, their contract with the Department, as they know doing so will cost them less and will not affect their ability to compete for other contracts.

On the basis of a report from the Comptroller and Auditor General, the Committee took evidence from the Department and Directly Operated Railways on protecting the taxpayer, performance of the franchise in public ownership and the lessons to be learnt.

Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 1

The Department did not undertake sufficient due diligence on the bid by National Express for the East Coast franchise.

National Express promised the largest ever payment for a passenger rail franchise, but then failed to meet its profit forecasts from the start of the contract and, following the economic downturn, quickly started to accumulate losses. Crucially, the Department did not test any of the bids for the franchise against the impact of an economic downturn. The Department should always test bids in future against different economic conditions.

This becomes more important with the move to much longer franchises of up to 22 years. The Department should improve its arrangements with franchisees to remove any incentive on bidders to make forecasts which are either too optimistic, thereby increasing the risk that the franchise might fail, or deliberately pessimistic, thereby increasing their expected profits. For instance, the Department should have been more rigorous in questioning National Express on its assessment that it could grow passenger revenue by 5%-12% per annum. By any measure, this appears to be an over-optimistic assessment of the business.

1.1 The Government partially agrees with the Committee's recommendation.

1.2 Whilst further work can be done to assess the potential risk of a franchise proposition, extensive work is already undertaken using informed sources (in this case the Department used independent information provided by Oxford Economics and Treasury forecasts). To undertake work on hypothetical scenarios could increase the risk of legal challenge on the validity of any source information used to create such scenarios, in turn adding potentially significant cost and risk of delay to the process.

1.2 As part of the evaluation of the bids for any franchise, the Department assesses the 'as bid' position, and analyses the deliverability of both the operational side of the proposition and assesses whether the revenue (and cost) assumptions applied by the bidder are realistic. It assesses both exogenous and endogenous assumptions, particularly in the case of management actions such as performance improvements and gate-line installations.

1.3 In undertaking its assessment of the bid, the Department will adjust the bid position internally to determine the level of risk to its delivery. The Department's expected budget for the life of the franchise will therefore reflect the risk adjusted position for the winning bidder, including any future potential revenue risk for which the Department may be liable.

1.5 National Express Group's bid for the franchise was ambitious, however it was not the highest bid received. At the time of the franchise award, positive economic growth was being forecast by the Treasury and OEF, which supported the view that the premia levels bid were realistic and achievable.

1.6 Nevertheless, the Government agrees that more should be done to assess the level of risk that may arise from an economic downturn. The importance of this issue is heightened with the move to longer franchises. Work is underway, in advance of letting the first longer term franchise that reviews what risk there is likely to be during a longer term franchise.

PAC CONCLUSION AND RECOMMENDATION 2

In public ownership, the franchise is now performing better than expected but the Department has still foregone some £330 million - £380 million of expected revenue.

Unlike other train operators, which continued to bear losses during the economic downturn, National Express did not have the resources or the inclination to fulfil the terms of its contract. The holding company had accumulated more than £1 billion in debt and needed to refinance this debt following the downturn. Part of the company's solution to this was to avoid heavy forecast losses on the East Coast franchise by negotiating with the Department to leave the contract. The Department should in future take greater care when assessing the financial strength of a company to ensure it will be able to support any of its franchises that get into financial difficulty. Specifically, the Department should avoid letting franchises to heavily indebted holding companies.

2.1 The Government partially agrees with the Committee's recommendation.

2.2 Department officials routinely monitor the financial wellbeing of both the Franchise holders and their respective parent companies. Officials monitor financial interests of the holding companies by assessing debt levels and share prices. The financial stability of the actual franchise operator is routinely monitored on both the railway period performance and the long term ability to meet supplier costs.

2.3 National Express East Coast, unlike many other Franchise Operators, in light of the economic downturn, was unable to reduce costs to the extent that some other operators were able. It is the Department's assessment that whilst National Express East Coast could have made more cost efficiencies in their business in order to survive longer, such was the severity of the downturn, the termination was inevitable as passenger revenue did not meet those expectations it made at franchise commencement.

2.4 The East Coast train operating company, currently in state ownership, is making net payments to the Department.

PAC CONCLUSION AND RECOMMENDATION 3

The Department entered into negotiations demanding the surrender of National Express's other two franchises when they could not legally demand they do so.

After National Express sought changes to the terms of the contract, the Department offered a deal requiring a payment of £200 million and the surrender of the company's other two franchises. However, legal advice indicated that the Department did not have a right to terminate the company's other two franchises and so ended up leaving them in place. Contracts should give the Department a clear right to terminate a holding company's other franchises.

3.1 The Government disagrees with the Committee's recommendation.

3.2 Each franchise agreement has cross default provisions therefore the Department is satisfied that it has the power to terminate affiliate Franchise Agreements, in appropriate circumstances.

3.3 Whilst the Committee is correct that National Express East Coast attempted to negotiate a settlement to relinquish control of each of its Franchise Agreements, the Department did consider both the impact in respect of other Franchise Agreements and what this behaviour may do, as well as the Department's contractual right to cross-default given the specific event of default that occurred under the National Express East Coast Franchise Agreement.

3.4 The Event of Default that arose in respect of the National Express East Coast Franchise Agreement did not demonstrate that the failure was one which was an endemic cause by the Parent Company, and as such did not indicate to the Department that this warranted the termination of the other two Franchise Agreements.

PAC CONCLUSION AND RECOMMENDATION 4

National Express paid £120 million to get out of a contractual obligation to pay the taxpayer £1.4 billion.

The penalty National Express paid to the Department amounted to less than 9% of contract value, which leads one to question whether the taxpayer has been adequately compensated. This compensation is further reduced by the extension granted to the other two franchises and the additional revenue support given by the Department. The Department should ensure that there are stronger financial penalties in contracts for failure to meet contractual obligations.

4.1 The Government partially agrees with the Committee's recommendation.

4.2 The full potential cost of negotiating a compensation deal with National Express East Coast – which could have created a precedent for other franchise companies facing similar recessionary pressures - was far greater than the balancing payment between that amount proposed by National Express and the amount finally received through recovery of, inter alia, its Performance Bond.

4.3 Under the terms of each Franchise Agreement let since 2007, the Department has contracted the use of loan facilities from Parent Companies that provide additional financial comfort to the franchisee in the event that additional funds are required. This is in addition to the Performance Bond that the Department has in place with all Franchise Operators to provide recovery of costs to the Department in the event that the Franchise Agreement is terminated.

4.4 The Government agrees that the financial penalties for default should be sufficient to provide a strong incentive to compliance, whilst delivering the best overall value for money. However, in recognition of the potential financial penalties, there is an associated cost.

PAC CONCLUSION AND RECOMMENDATION 5

The Department turned down an offer from National Express of an extra £30 million for a "no fault" exit.

It judged that accepting such an offer would have increased the risk of other franchises seeking a similar settlement, costing the Department and the taxpayer £140-£280 million in the long run, according to the NAO. The Department wanted the reputational damage for National Express, of having one of its franchises terminated, to act as a clear warning signal to others. But the Department undermined that position by telling National Express just over a year after the termination that the failure would not be held against the company if it bid for future franchises.

Since the East Coast termination, other franchises have been in financial difficulty, and the holding companies have not sought to hand them back. However, the Department has potentially incentivised other holding companies with loss-making franchises to terminate, rather than renegotiate, their contract with the Department, as they know doing so will cost them less and will not affect their ability to compete for other contracts. The Department should make it clear to holding companies that failure to deliver obligations will have serious lasting implications.

5.1 The Government disagrees with the Committee's recommendation.

5.2 Whilst National Express offered £150 million to walk away from the franchise on a 'no fault' basis, the offer was analysed carefully and was not taken up because it was based on an inflated value of the franchise assets.

5.3 The Department does not believe that it has incentivised other train operating companies to terminate franchises. There was a real danger that had the Department renegotiated the franchise, others who were feeling financial pressure would have asked for similar treatment. This carried a significant risk of exposure to the taxpayer and the Department's refusal to renegotiate mitigated that risk.

PAC CONCLUSION AND RECOMMENDATION 6

Following a period of deterioration, punctuality on the line is now beginning to improve and investments are being made in new technology, fleet maintenance and customer service.

The unfortunate recent history of the franchise may well have caused under-investment in a service described to us as the "jewel in the railway crown". The investment of taxpayers' money while the franchise has been in public ownership should help to secure a good deal when it is retendered to the private sector in 2012. The Committee expects the Department to ensure that this investment is fully recovered.

6.1 The Government partially agrees with the Committee's recommendation.

6.2 Performance on the line remains a concern and is the subject of scrutiny by the Office of Rail Regulation, Network Rail, East Coast and the Department. East Coast has made a number of improvements to the franchise since assuming control. These improvements are enhancing the value of the franchise, the costs of which will be recovered when the franchise is returned to the private sector.

6.3 Performance has recently been affected by infrastructure failures and East Coast is working closely with Network Rail to improve performance on the route. Investments in rolling stock have made the fleet more reliable, improving its own performance and the impact on other operators.

PAC CONCLUSION AND RECOMMENDATION 7

Forecasts of future passenger revenues across the rail network have frequently proved inaccurate.

The high proportion of discretionary business and leisure travel on the East Coast line offers commercial opportunities to attract new passengers but makes revenues susceptible to changes in the economy. Forecasting is not straightforward as it depends on assumptions about the number and types of future journeys as well as the prices charged. However, such complications are hardly new and the Committee has in the past highlighted the poor quality of data on passenger journeys.

As more sophisticated data on passenger journeys becomes available, the Department should validate the assumptions that lie behind passenger revenue forecasts for each franchise. These should feed this into its wider budgeting for the amount of support that may be required from the taxpayer.

7.1. The Government partially agrees with the Committee's recommendation.

7.2 The Department will continue to work with industry partners in order to develop more robust forecasts for both revenue and passenger volume growth.

7.3 A large part of the research activity in this area is conducted through the Passenger Demand Forecasting Council, which includes representatives from the Train Operating Companies, the Department, Network Rail, Transport for London, Transport Scotland, the Passenger Transport Executive Group and the Office of Rail Regulation. The outcome of the latest research is assessed by the Department on an on-going basis and, if deemed to be sufficiently robust, included in its forecasting methodology. The Department is also improving its dataset of actual train usage (passenger counts). This data is used by the Department to validate and improve its forecasts.

Fortieth Report

Cabinet Office

Information and Communications Technology in Government

Report Summary from the Committee

Information and Communications Technology (ICT) has the power to transform public services and generate efficiencies. While the history of ICT in government has included some successful projects, there have been far too many expensive and regrettable failures. ICT is not well enough embedded in departments' business, and as a result not enough reform programmes have had ICT at the core. Problems have arisen where expectations for systems are too grand and the proposals from suppliers are uNetwork Railealistic. Projects have been too big, too long, too ambitious and out of date by the time the ICT is implemented.

The Commitrtee welcomes the direction and principles of the Government's new strategy for ICT (the Strategy). But this is not the first time that Government has set out to deliver better outcomes for citizens and businesses, and large scale reductions in operational costs using ICT. Success will depend on greater rates of adoption of technology, and a cultural shift to encourage genuinely different ways of working in the Civil Service that will stimulate behaviour change by suppliers.

The Strategy is ambitious, with some 30 actions to be delivered in just 24 months. However, it lacks quantitative targets, or a baseline of current performance, which will make it difficult to measure success. The Committee looks forward to the publication in August 2011 of the implementation plan, which the Committee expects will include milestones on which the Committee can hold Government to account.

The Committee welcomes the differences between this and previous strategies. The Efficiency and Reform Group (ERG) will insist on shorter, more iterative projects that take no more than two to three years, will step in and micro-manage a department's project if required, will promote greater input from smaller business suppliers, and will require a focus on designing services around the customer.

The Committee has serious concerns about the Strategy. It lacks detail about the Government's approach to cyber-security, which is worrying given the drive for more Government services to move online. Government also has not yet assessed the size of its existing ICT workforce or the number of ICT people or the skills it will need to deliver its strategy. A longstanding issue has been that Senior Responsible Owners have had too little experience and too little time to devote to a project, and leave their posts before they have had to live with the consequences. The Committee are concerned that not enough has been done to deal with this issue, and the ERG should address it.

ERG has only a small team of experts to keep on top of more than 50 major projects. The Committee has concerns that ERG could not provide any detail on the nature or the number of its major projects. The Committee recognises that the Strategy is in its early stages and we will watch progress with interest. Ultimately, success will be shown when complex change programmes like the Department for Work and Pension's Universal Credit are delivered on time and to budget, and the Committee sees fewer critical NAO reports on projects like the NHS Programme for IT and the Rural Payments Agency's Single Payment Scheme.

On the basis of a report by the Comptroller and Auditor General, the Committee took evidence from the Cabinet Office on the Government's new strategy for ICT2 and the practical steps necessary to implement its 30 key actions.

Government responses to the Committee’s conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 1

The Committee welcomes the direction and principles of the Government's new strategy for ICT (the Strategy), but it is very ambitious and short on detail about how it will be delivered.

There is a long way to go before government can say it is living up to its claim that there is "no such thing as an IT project". This can only be achieved when ICT is embedded in departments' business and government reform programmes have ICT at the core - key objectives of the new Strategy. The following recommendations are intended to help Cabinet Office's Efficiency and Reform Group (ERG) to tackle some of the challenges that lie ahead.

1.1 The Government agrees with the Committee’s recommendation.

1.2 The Strategic Implementation Plan (SIP), to be published in September 2011, will set out the details of how the government will deliver all of the strategy commitments.

1.3 The Government has already made significant improvements to the management of IT projects including introducing new ICT controls, increasing transparency, creating robust governance arrangements and improving capability.

1.4 The Government is committed to ensuring that policy and IT solutions are developed hand in hand. There is no such thing as an IT project; there are only business projects that involve IT.

PAC CONCLUSION AND RECOMMENDATION 2

The Strategy lacks a baseline or metrics to measure progress. Simply listing actions to be achieved within two years is not sufficient.

The Strategy implementation plan, due to be published in August 2011, should include a small number of measurable business outcomes, or direct indicators, to enable government and this Committee to evaluate success and whether the Strategy is delivering value for money.

2.1 The Government agrees with the Committee’s recommendation.

2.2 The SIP will, wherever possible, set out measurable outcomes and performance indicators, which will be transparent and available for all to scrutinise. The Government has published Quarterly Data Summary (QDS) to provide a snapshot on how each Department is spending its budget, the results it has achieved and how it is deploying its workforce. More specifically, the QDS will provide figures on the total 3rd party ICT costs and the cost of desktop provision per FTE.

PAC CONCLUSION AND RECOMMENDATION 3

The Strategy cannot be delivered by the Cabinet Office alone - its successful implementation relies on its new principles being adopted across the Government ICT and supplier communities, Chief Information Officers and by policy makers in the wider civil service.

The Strategy envisages a small but powerful capability in the ERG, which can control and intervene in Departments' projects. To be effective and successfully deliver its strategy for ICT and major projects, ERG should use its new powers selectively and be able to demonstrate that it has achieved buy-in from Departments and suppliers.

3.1 The Government agrees with the Committee’s recommendation.

3.2 The Government has established a CIO Delivery Board, comprising the largest delivery Departments who will take responsibility for the delivery of specific strategy actions and will leverage their existing expertise and resources to drive implementation. The CIO Council led by the Government Chief Information Officer, other Government Departments, local Government representatives and suppliers will support the delivery of the strategy. The SIP will describe how the Government will deliver all of the strategy commitments, including accountability.

PAC CONCLUSION AND RECOMMENDATION 4

ICT-enabled projects have been too big, too long and too ambitious and we welcome the move to shorter, more iterative projects.

ERG is introducing 'starting gate reviews' for new ICT projects to test whether projects are small enough and deliverable. It should publish its 'starting gate reviews' and other significant reviews carried out over the life of the project.

4.1 The Government agrees with the Committee's recommendation.

4.2 As part of a sea change in the oversight of central Government's major projects, the new Major Projects Authority (MPA) was set up. The MPA are committed to publishing more data and work is currently underway on the publication, by December 2011, of an Annual Report on Government Major Projects. The Department is also considering what other information could be published.

PAC CONCLUSION AND RECOMMENDATION 5

Value for money in ICT procurement relies on a mixed market of suppliers. The Strategy includes an aspiration to open up the government ICT market to small- and medium-sized enterprises (SMEs).

ERG now needs to set out what the Government will do to encourage more involvement by SMEs, and how it will measure success.

5.1 The Government agrees with the Committee's recommendation.

5.2 The Government has set out clearly, at announcements made by the PM and MCO at the 11 February SME Strategic Supplier Summit how it will encourage more SME involvement and transparency over the number of contracts awarded to SMEs, including the appointment of a Crown Representative to represent small suppliers in government. Plans for further action are under development and will be announced in due course. The Government's overall aspiration is to do 25% of its business with SMEs.

PAC CONCLUSION AND RECOMMENDATION 6

The Government plans to move more public services online and, rightly, to stress the importance of designing services around the needs of the user. However, approximately nine million people have never used the Internet, and they must not be excluded.

ERG and other relevant Departments should withhold sign-off of additional online services until they are satisfied that the service is designed for users. ERG should also continue to ensure that online services are accessible through libraries, post offices or other alternative means. When new services are launched, these alternatives should be well publicised.

6.1 The Government agrees with the Committee's recommendation.

6.2 The Government is committed to ensuring that online services are designed and focused on users. The Government has a duty to provide for all and therefore an appropriate "assisted digital" strategy will be developed for each service to ensure that people are supported to access information and services from Government. These services will be developed based on user requirements and will be delivered through appropriate channels, including libraries, the Post Office and other suitable intermediaries. No one will be excluded from accessing services by the move to digital as the default channel for service delivery.

6.3 The Government has accepted the recommendations of the UK Digital Champion, Martha Lane Fox to drive better services and lower costs through the use of digital technology. As a direct result of these recommendations a new Executive Director of Digital has been appointed who is responsible for overseeing and improving all of the Government's online presence.

PAC CONCLUSION AND RECOMMENDATION 7

The Strategy only makes one reference to cyber-security. This is particularly concerning given the move to more government services online.

The Government has committed to increase the use of new technologies and sharing of information, which rely on the Internet. ERG should clarify in its implementation plan how cyber-security will be integrated into its strategy for ICT.

7.1. The Government agrees with the Committee's recommendation

7.2 Cyber-security considerations are embedded into the design of the delivery of all elements of the Strategy. The SIP will set out key dependencies and risks to delivery, including cyber security and information and identity assurance, and Government's approach to mitigating and solving these issues.

PAC CONCLUSION AND RECOMMENDATION 8

Government has not yet assessed the number of ICT people it has or the capacity and skills it will need in the future.

In preparing its Capability Strategy for ICT, ERG should establish the size and capability of the existing government ICT workforce, including the number of cyber-security professionals, and build a model to help predict future demand.

8.1 The Government agrees with the Committee's recommendation

8.2 The Government is committed to publishing an ICT Capability Strategy by October 2011 and the Committee's views will be considered as part of the process in developing the strategy.

PAC CONCLUSION AND RECOMMENDATION 9

There are no proposals in the Strategy to address the longstanding problems of high turnover of Senior Responsible Owners (SROs), their lack of experience and their lack of accountability.

While the Committee recognises that shorter, more manageably-sized projects will help, the ERG should make proposals to keep SROs in post for longer where possible, and raise and maintain their level of skills, in line with the Government's advice on accountability. The identity of SROs should be available on departmental websites, along with their dates of appointment.

9.1 The Government agrees with the Committee's recommendation.

9.2 The Government is engaging with SROs to ensure that they are directly in contact with the Major Projects Authority (MPA). As the MPA work programme rolls out, this will include a specific work stream on SRO capability, which will set out detailed plans for managing the expectation that SROs will remain in post until a suitable break point in a major programme. To upgrade the project, programme and contract management skills across Government, the Department is also setting up a new project management academy.

Forty First Report

Office of Rail Regulation (ORR) and Department for Transport (DFT)

Regulating Network Rail's efficiency

Report Summary from the Committee

The Office of Rail Regulation (the Regulator) is the independent economic and safety regulator of the rail industry in England, Scotland and Wales. The Regulator's duties include promoting economy and efficiency in the rail industry with much of its work focusing on Network Rail, the owner and monopoly provider of the national rail network, including track, signalling and stations.

Network Rail does not face normal commercial pressures from investors and lenders to improve efficiency as it is a not-for-dividend company without shareholders, financed by debt guaranteed by the Government. It is therefore the role of the Regulator to hold Network Rail to account for its performance and to incentivise it to become more efficient. To this end, the Regulator sets efficiency targets when it determines the limits on fees Network Rail can charge train operators for use of tracks, stations and depots. It can also impose financial penalties, although the usefulness of this sanction is questionable as, by taking money away from investment in the railways, its impact falls mainly on passengers.

The Department for Transport (the Department) acknowledged the finding of Sir Roy McNulty's recent review of the rail industry1, that the rail industry continued to fail to achieve effective value for money. In the five years to 2008-09, Network Rail reported efficiency gains of 27%, missing the target set by the Regulator of 31%, a shortfall of £204 million.

Overall the Committee does not believe that the Regulator exerted sufficient pressure on Network Rail to improve its efficiency, and that there is an absence of effective sanctions for underperformance in the system. The Committee were particularly concerned that the Regulator did not enforce a stronger link between performance and bonus payments to Network Rail's senior managers, leading to excessive bonus and performance payments being paid to senior executives.

The relationship between Network Rail, the Regulator and their advisors appears to the Committee to be too cosy, with some companies hired by the Regulator to provide an independent view of Network Rail also providing advice to them. The Committee questions whether this serves the interest of independent review.

The Committee believes Network Rail should be more accountable for its use of public money, and more transparent in its operations. In 2009-10, Network Rail received £3.7 billion in direct taxpayer support, yet it is not directly accountable to Parliament. The Comptroller and Auditor General should have full access to Network Rail so that Parliament can scrutinise Network Rail's value for money.

The Regulator estimates that the gap in efficiency between Network Rail and the most efficient European operators was 34% to 40% in 2008, a position of relative inefficiencies which has not improved since 2003. The reasons for the gap are not properly understood, although Network Rail told us that they believed the single overriding factor was the difficulty of access to the railways to carry out maintenance work, which reduced its *Realising the Potential of GB Rail: Report of the Rail Value for Money Study* , May 2011 productivity and thereby increased its costs. The Regulator will need to conduct more detailed analysis to understand the reasons for the efficiency gap, and what can be done to address them. It is a concern to the committee that after 10 years in existence the Regulator has still not carried out this work.

As part of determining Network Rail's financial settlement, the Regulator takes into account the costs the company is likely to incur including the cost of inflation. In its last review in 2008, it made an assumption that Network Rail's operating costs would be 8% above inflation over a five year period. The Committee found this to be over-generous, reducing the pressure on Network Rail to find efficiencies and reduce its costs.

Network Rail plans to reduce expenditure by about £1 billion on renewing tracks and replacing signalling over the five years to 2013-14. It is reliant on this reduction to meet most of its efficiency target. It intends to achieve this by a more selective approach to rail replacement, but there is considerable uncertainty over whether deferring this work is genuinely efficient or simply delaying costs for the future. Network Rail and the Regulator need to carry out further work to understand this, and to ensure that Network Rail is making real and sustainable efficiencies, which are safe.

Both punctuality and passenger safety have improved in recent years, with 91.3% of trains meeting the punctuality target in 2009-10, and the Committee heard that the UK railway is amongst the safest in Europe. The Committee agree with the Regulator that safety is paramount and must not be traded-off against other outcomes. But with growing demand for more trains, limited capacity and less maintenance, it is important that trade-offs between safety, efficiency, capacity and punctuality are made explicit.

Overall, the complex industry structure creates risks to value for money, with fragmentation, duplication of effort and misaligned incentives. This has been confirmed by Sir Roy McNulty's review. The Committee welcomes the Department's commitments to improve governance, transparency, and clarity of roles in the rail industry. The Committee nevertheless would have expected the Department to have a clearer idea of the priorities and issues to be addressed at this stage. The Committee look forward to the Department's response to Sir Roy McNulty's review, and will return to this issue when the Department decides on the changes required to improve efficiency.

On the basis of a report from the Comptroller and Auditor General, the Committee took evidence from the Regulator, Network Rail and the Department.

Office of Rail Regulation and Government responses to the Committee's conclusions and recommendations

PAC CONCLUSION AND RECOMMENDATION 1

The sanctions and incentives on Network Rail, in particular penalties and bonuses, have not been effective in driving the company's efficiency.

The McNulty review confirmed that achievable value for money savings have not been realised properly. The Department agreed that the industry needs to focus on this issue. The Regulator reported that Network Rail had made efficiency gains of 27% in the five years to 2008-09, which fell short of the 31% target, a shortfall of £204m. Network Rail is up to 40% less efficient than the most efficient European operators, and this relative gap has not narrowed over the period in question.

The Committee doubts whether the Regulator is able to exert sufficient pressure on Network Rail's performance and are concerned that the main sanction of fines is just taking money away from investment in the railways. The Regulator should put in place a more robust performance management system and the Department should review the Regulator's powers. As part of this, the Regulator's assessment of Network Rail's performance should directly inform the level of bonuses paid to its executives. The high level of performance pay and bonuses enjoyed by previous rail executives is simply unacceptable given their inability to meet the efficiency target.

1.1 The Office of Rail Regulation (ORR) partially agrees with the Committee's recommendation.

1.2 ORR has evidence that the regulatory regime has had a substantial effect in driving Network Rail to make substantial improvements in efficiency. By the end of Control Period 4 (CP4), ORR expects Network Rail to have made more than £15 billion in savings compared to the situation in 2003-04 (immediately prior to CP3). Although Network Rail did not achieve the full 31% efficiency assumption in CP3, ORR reflected this in its assessment of the gap facing Network Rail and in the funding assumptions and efficiency performance requirements it set for CP4. These are challenging, but achievable, and are established as part of a wider set of demanding outputs and obligations on Network Rail that together are planned to deliver significant improvements in the performance of the railway by the end of CP4. The issues covered include: safety; train performance; network availability; and capacity.

1.3 ORR closely monitors and reports extensively on Network Rail's performance, including financial and efficiency. It raises issues of concern directly with the company and applies pressure to deal with those concerns in a number of ways. Most concerns are resolved satisfactorily before they reach the stage where formal enforcement action is required. ORR publishes extensive assessments of the company's delivery and asset-management performance four times a year and assessments of its efficiency annually. ORR continues to keep its performance-monitoring regime under constant review, making improvements as necessary.

1.4 ORR has a range of enforcement sanctions at its disposal, of which fines are only one part. For example, enforcement notices require Network Rail or any other licence holder to make specific improvements by specific dates. For example, engineering overruns over the 2008 new year led to a £14 million penalty and ORR instructed Network Rail to produce and implement an improvement plan to address fundamental weaknesses in its procedures for conducting major engineering works including risk management, site management, supplier management and communications. This plan was successfully delivered within 12 months and has substantially changed behaviour – the level of possession overruns has reduced significantly, with no notable new cases.

1.5 ORR is fundamentally committed to the principle that remuneration must reflect performance. ORR is already in discussion with Network Rail on its proposed new management incentive plan (MIP), to ensure that its new arrangements comply with the licence and the three high-level objectives for the MIP that were established by ORR in March 2011. These are: incentivise sustainable delivery of all of Network Rail's outputs and obligations; incentivise outperformance, reflecting real management effort, of the challenging efficiency assumptions ORR established for CP4; and accountability and transparency on the part of Network Rail, which includes seeking the views of its funders and members on its proposed remuneration arrangements and levels – and taking these into account in its remuneration decisions. In making its decisions on bonuses, Network Rail will also need to produce a public value for money case of its senior executive remuneration arrangements. Network Rail's remuneration committee will be required to take account of ORR's performance assessments and justify in a public and transparent fashion the bonuses that the company's top executives will earn. Bonuses must reflect long-term sustainable improvements in the network and management effort. Penalties imposed on Network Rail will also need to be taken into account.

PAC CONCLUSION AND RECOMMENDATION 2

The Regulator's allowance for inflation in Network Rail's financial settlement is too generous, reducing the pressure to drive down costs.

The allowance of 8% above RPI for operating expenditure over a five-year period was a broad brush assumption which did not take into account Network Rail's purchasing power in some markets or its ability to control its own salary costs. This appeared to us ridiculously overgenerous and it also means that the inflationary risk lies with the Department rather than with Network Rail. The Regulator should adopt a more sophisticated and rigorous approach to setting inflation assumptions in its next financial settlement in 2013. In doing so, it should clearly demonstrate that it has taken account of National Rail's ability to control its costs.

2.1 ORR disagrees with the Committee's conclusion. However, ORR agrees with the recommendations and recognises the importance of being rigorous when setting inflation assumptions.

2.2 Extensive work on input prices specific to Network Rail's costs was undertaken in the 2008 Periodic Review. ORR's assessment did consider the extent to which Network Rail can control its own costs, for example its salary costs. At the time, there was good evidence to suggest that over the course of CP3, input prices had run ahead of general economy-wide input prices reflected in the RPI – and were likely to do so again over CP4. The decisions that ORR made on input prices were made as part of the overall set of judgements and decisions on the CP4 determination of Network Rail's funding and outputs.

2.3 ORR welcomes the wider debate on input prices and indexation, and is consulting on these issues in its preparations for the 2013 Periodic Review. ORR will work with other regulators through the Joint Regulators' Group on this issue of common concern. It will also review its approach to setting inflation and input price assumptions thoroughly to ensure that it establishes an approach for CP5 that is sufficiently challenging for Network Rail – including ensuring that it has strong incentives to control its cost base and make efficiency improvements.

PAC CONCLUSION AND RECOMMENDATION 3

The Committee are not convinced that the Regulator can distinguish between genuine efficiency savings and the deferral of work which simply increases costs in the future.

Network Rail plans to defer about £1 billion worth of renewals work, such as renewing tracks and replacing signalling, over the five years to 2013-14. Without doing so, it will not meet its efficiency target. The Regulator must work with Network Rail to obtain robust evidence, including data on track usage and condition, to enable it to judge whether deferring maintenance work on this scale is efficient, sustainable and safe. The Regulator should publish the evidence that supports its judgement.

3.1 ORR disagrees with the Committee's conclusion. However, ORR does recognise that the recommendations are sound and notes that these are already in operation as part of the regulatory regime.

3.2 Although it will always be difficult, and a degree of judgement will always be required, ORR undertakes annual assessments of Network Rail's expenditure and efficiency and makes a clear distinction between efficiency and deferral. It has made such assessments for many years. Reductions in renewal volumes which do not jeopardise the safe delivery of required outputs and / or the long term sustainable condition and performance of the railway infrastructure are a legitimate and important source of efficiency ('scope efficiency'). ORR assesses Network Rail's renewal levels against the company's asset policies (agreed with the regulator) in order to determine whether there has been deferral and the network is being managed in a sustainable way. Deferral is not counted as efficiency and ORR takes a very firm line on this. Where there are uncertainties, ORR adopts a cautious line in assessing efficiency.

3.3 ORR is aware that distinguishing scope efficiency from inefficient deferral is difficult in the context of an industry characterised by long asset lives and a relatively poor understanding of asset condition and its longer-term impacts on future network capacity and availability. This is a widely acknowledged area of difficulty across network infrastructure industries.

3.4 ORR performs both top-down and bottom-up efficiency benchmarking to address these issues. It also takes account of potential uncertainties by exercising regulatory judgement around its efficiency estimates. It also looks at ranges as opposed to point estimates of efficiency early in the periodic review process. It will then consult with industry stakeholders before converging these range estimates to more specific spot estimates at Determination stage.

3.5 ORR did not attempt a definitive efficiency assessment of renewals for 2009-10, as Network Rail was revising its asset policies – which made it impossible to do so. ORR is working on its assessment of the position at 31 March 2011. However ORR has concerns about the robustness of Network Rail's own analysis, which it is challenging. ORR's assessment of this issue should be available in early autumn 2011. ORR expects Network Rail to make sure that implementation of its asset condition assessment and policies are on the trajectory to which it has committed, and will hold Network Rail to account if there is significant deviation from the planned delivery path.

3.6 ORR will continue to work closely with Network Rail on this and will – as it always has done – publish the evidence underlying its analysis and judgements.

PAC CONCLUSION AND RECOMMENDATION 4

The reasons for the gap between Network Rail's efficiency and that of the most efficient European operators are not fully understood.

The Regulator's international benchmarking work was an important contribution to identifying the scale of the efficiency challenge for Network Rail in the five years to 2013-14. However it is disappointing that after 10 years' existence the Regulator still does not properly understand the reasons for the gap. The Regulator should improve its understanding of how much is attributable to different factors. The Regulator should publish the results of this analysis in its next Periodic Review in 2013, setting out timescales and the extent to which it expects those factors can be addressed by Network Rail.

4.1 ORR partially agrees with the Committee's recommendation.

4.2 ORR agrees that the reasons for the gap are not known in full, though it is unlikely that it will ever be possible to explain every single difference. This is partly because it depends on exactly how differences, such as the size of network or number of trains, are allowed for. However, extensive work has been done and will be done to understand more fully the reasons for the gap. It is also worth noting that ORR is not aware of any other regulated sector which has done such comprehensive 'gap analysis' between companies/countries.

4.3 Prior to the 2008 Periodic Review, there was very little emphasis on international benchmarking. This was partly because it is very challenging to undertake. Also, it was not a priority at the time, given that the core causes of Network Rail's inefficiency were widely recognised following both Hatfield and Railtrack going into administration.

4.4 This is a key issue for PR13 and ORR will develop its understanding further to inform the decisions it takes on efficiency in the periodic review. ORR will be undertaking top-down (statistical analysis) and bottom-up (engineering based) benchmarking of Network Rail's operating, maintenance, and renewal expenditure and practices. It will be doing further work to understand the efficiency gap that Network Rail faces compared to other international rail infrastructure managers, covering both the size of the gap and the reasons for it. The work will consider the working methods, technologies and management practices employed by Network Rail compared to its peers.

4.5 ORR will use expert consultants as necessary and it will also scrutinise closely the work that it is requiring Network Rail to do in this area, as part of the company's submissions to PR13. Based on results from different analyses, ORR will make judgements of the overall extent of the efficiency gap faced by Network Rail at the beginning of CP5 compared to better-performing railways or companies in other sectors. On the basis of this value, ORR will set challenging but achievable assumptions on the level of efficient expenditure Network Rail requires in CP5 to deliver its outputs and obligations.

4.6 ORR's comparative efficiency studies aimed at assessing Network Rail's efficient level of expenditure for CP5 will take place over the next two years as part of the periodic review process. The Initial Industry Plan will be published by the end of September 2011. ORR's advice to Ministers on the High Level Output Specification (HLOS; the Government's requirements for the next regulatory settlement) and Statement of Funds Available (SoFA) will be completed by February 2012. Government will then make a decision on these by July 2012. ORR's final assessment of Network Rail's Strategic Business Plan (SBP) will lead to its Determination for CP5 in 2013. CP5 will start on 1 April 2014.

PAC CONCLUSION AND RECOMMENDATION 5

Network Rail told us that punctuality could not be improved to 95% in five years' time without making trade-offs with efficiency and capacity

Punctuality has improved in recent years, with 91.3% of trains meeting the target in 2009-10, and we heard that the UK railway is amongst the safest in Europe. The Committee support the Regulator's view that in seeking to reduce costs, Network Rail must not compromise safety. The Department, in preparing for the next regulatory settlement in 2013, should publish what it realistically expects can be achieved in terms of efficiency, capacity and punctuality, noting how it has assessed the trade-offs between them.

5.1 The Government partially agrees with the Committee's recommendation. It is important to determine what can be realistically achieved in terms of efficiency, capacity and punctuality, and to understand the trade-off between them.

5.2 The format of the Government's High Level Output Specification (HLOS) has yet to be decided. It will build upon the Government's strategy for the rail industry and response to the McNulty Report recommendations, expected to be published in November 2011. It has yet to be determined whether publishing requirements for each of capacity, efficiency and punctuality and the assessment of trade-offs between them is the appropriate role for Government. It may be that one or more elements are better devolved to the rail industry.

PAC CONCLUSION AND RECOMMENDATION 6

The Committee are concerned there may be duplication between the organisations involved in reviewing Network Rail's efficiency and that the relationships between them may be too cosy

The Department for Transport, the Regulator, 'Independent Reporters', Network Rail itself and other funders all have roles in reviewing Network Rail's efficiency. Independent Reporters are appointed jointly by Network Rail and the Regulator but may also perform other work for Network Rail, creating at worst a potential conflict of interest and at best too cosy a relationship between various players. There is a lack of clarity about who is being held to account and who is commissioning work. The Regulator should strengthen arrangements to guarantee the independence of its Reporters, and should work with the Department and other funders to agree a protocol to ensure that work to assess and review Network Rail's efficiency is not duplicated.

6.1 ORR disagrees agree with the Committee's recommendation.

6.2 ORR's relationship with Network Rail is far from 'cosy'. ORR is clear that reporters play a valuable role and believes that all parties are clear about who is going to be held to account. They operate according to mandates set out by ORR, although they are funded by Network Rail. ORR would generally seek to agree mandates with Network Rail, so that both organisations can get value from the work. Ultimately, if necessary, ORR can determine both what reporters do and the content of the mandates if it considers that an issue needs assessing, even if Network Rail does not agree. Reporters are independent and must be seen to be as such, performing robust and professional work to retain the credibility of both ORR and Network Rail.

6.3 Reporters help to avoid costly and confusing 'battles of consultants'. They also provide an independent assessment of Network Rail's performance and processes, using recognised experts to comprehensively review its data-, asset management- and enhancement projects. ORR is confident that the reporters present objective recommendations to support Network Rail improvement.

6.4 ORR is very aware of the risks of reporters not being sufficiently independent and so it checks very carefully that the reporter's independence is not compromised, both generally and for each individual assignment. It requires reporters to acknowledge any conflicts of interest on all mandates that they are involved in. ORR would not commission work from a reporter if any such conflict of interest existed, and indeed in recent weeks it withdrew a mandate and allocated it to a different reporter for that reason. Reports that have been produced by the reporters demonstrate that the work is independent and professional and that, where justified, is constructively critical of Network Rail – for instance the recent report on Network Rail's unit cost framework. ORR regularly reviews the performance of all reporters, including any concerns regarding their independence and performance.

6.5 ORR reviews its overall arrangements from time to time; and will do so again before the end of 2011.

6.6 ORR is very clear how it monitors Network Rail's efficiency and delivery of its commitments – and that it holds the company to account for this. ORR reports publicly on performance and delivery every three months and on efficiency annually. ORR also discusses Network Rail's efficiency monitoring directly with the industry's main funders. ORR is not aware of any significant work to assess efficiency currently being carried out by the Department for Transport. This is with the exception of certain major enhancements, where it has assessed cost directly (a good example being Thameslink).

6.7 Nonetheless, ORR will discuss this recommendation with the Department for Transport to ensure that roles and responsibilities are clear. If it proves necessary, ORR will agree a protocol.

PAC CONCLUSION AND RECOMMENDATION 7

The complex structure of the rail industry creates inefficiencies and risks to value for money

Because of the way Network Rail is funded, any financial penalties the Regulator imposes are ultimately borne by taxpayers and passengers, rather than by private shareholders. The fragmented structure of the rail industry also contains inherent inefficiencies such as duplication of effort and conflicting incentives, leading to potential confrontation between the bodies involved. The Committee welcomes the Department's commitments to improve the governance and transparency of Network Rail, and to clarify roles in the rail industry more widely. The Committee nevertheless would have expected the Department to have a clearer idea of the priorities and issues to be addressed at this stage. In its response to Sir Roy McNulty's review the Department should be absolutely explicit about how any structural changes it proposes will improve efficiency. The Committee will return to this issue when the Department has made its decision.

7.1. The Government agrees with the Committee's recommendation that changes to the structure of the railway should be clearly aligned to efficiency gains.

7.2 Following the publication of Sir Roy McNulty's Rail Value for Money Study, the Government is working together with ORR and the rail industry to develop measures which will promote value for money. In recognition of the disruption that arises from major structural reform, the Government's intention is to achieve this without legislation. The Government will publish the details of its proposals later in the year.

PAC CONCLUSION AND RECOMMENDATION 8

Despite the levels of public subsidy it receives, Network Rail is not directly accountable to Parliament.

The Department should provide the Comptroller and Auditor General with full access to Network Rail so that Parliament can scrutinise Network Rail's value for money.

8.1 The Government does not agree with the Committee's recommendation.

8.2 Independent scrutiny and greater transparency of Network Rail are important, but Government is not currently persuaded that the best way to achieve this is through extending the role of the Comptroller and Auditor General (C&AG). ORR, which is itself open to audit by the C&AG, has access to the information it needs from Network Rail to scrutinise the company's performance and ensure that it is delivering value for money on the public subsidy it receives. Extending the role of the C&AG would therefore result in an unnecessary duplication of functions.

8.3 Furthermore, at a level of principle the Government believes the remit of the C&AG should not be extended to companies in the private sector. Network Rail's private sector status has been determined by the independent Office of National Statistics (ONS).

PAC CONCLUSION AND RECOMMENDATION 9

The Committee believe that the Regulator should have full access to the direct agreements between Network Rail and funders.

9.1 The Government agrees with the Committee's recommendation.

9.2 The Government has previously ensured that the ORR has had full access to these agreements in any event. This includes projects such as Thameslink and Crossrail, where ORR was fully consulted on the content of these documents and approved the protocols between the Department for Transport and Network Rail.

PAC CONCLUSION AND RECOMMENDATION 10

The internal operations of Network Rail are not transparent.

The Committee are concerned about Network Rail's use of 'compromise agreements' with departing employees, and that a review by the Regulator has been required to investigate the delayed disclosure by Network Rail of an issue regarding level crossing safety. The Committee are concerned that Network Rail was not able to tell us the total value of compromise agreements it had entered into. The Department and the Regulator should ensure that Network Rail is subject to the same transparency requirements as public bodies, with full application of the provisions of the Freedom of Information Act.

10.1 The Government partially agrees with the Committee's recommendation.

10.2 The Government shares the Committee's concerns regarding the transparency of Network Rail, but is not currently convinced that formal inclusion within the scope of the Freedom of Information Act is the best means of securing an improvement. The Government notes that such an inclusion would not be compatible with Network Rail's private sector status, as determined by the independent ONS. The Government further note that as legal advice indicates that Network Rail is not classed as a public authority under the terms of the Freedom of Information Act, any moves to include the company within the scope of the Act would require primary legislation. This would not, therefore, be possible to implement quickly.

10.3 However, the Government is working with Network Rail to explore other options for enhancing the transparency of the company and will publish its detailed proposals on this issue in due course.

PAC CONCLUSION AND RECOMMENDATION 11

The Committee are concerned at the financial impact of cable thefts on the rail system. The Department should address the issue urgently and provide us with a detailed action plan within six months.

11.1 The Government agrees with the Committee's recommendation.

11.2 The Government and ORR fully appreciate the substantial and growing cost imposed by cable theft, not just to the rail industry but also a wide range of other sectors, and the consequent impact on businesses, communities and individuals around the country. For the rail industry, Network Rail, with the support of British Transport Police and the Association of Chief Police Officers, is already taking a wide range of steps to tackle the problem. In addition, given the cross-sectoral impact of the issue, which is exacerbated by the apparent ease with which stolen metal can be disposed of, the Government is considering whether further measures might be appropriate to update the legislative regime governing the scrap metal industry.

11.3 The Government will, as requested, provide the Committee with a further response within six months setting out the actions in hand.

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