A SHORT GUIDE TO

Structured cost reduction

Introduction

The National Audit Office exists to provide independent opinion and evidence to assist Parliament in holding the Government to account. We can only do this effectively if we retain our ability to comment objectively and independently on what government does, and we cannot therefore act as an adviser on specific decisions the Government takes. We can, however, reasonably and helpfully point out what we understand to be principles of good practice in particular areas, and that is what this Short Guide, one of a series, aims to achieve.

Drawing on our financial audit and value for money work, we have identified a number of areas where government is currently facing particular challenges. One challenge is for government to adopt a more structured approach to cost savings and this paper highlights key issues for public bodies to consider in facing this challenge.

Summary

Departments are under increasing pressure to reduce costs. The scale of cost reduction required means that they will have to look beyond immediate short term savings and think more radically about how to take cost out of the business and how to sustain this longer term. This will require strong leadership, disciplined financial management and a corresponding change in organisational culture. Our work has repeatedly highlighted areas of waste in government where complex processes, lack of information and poor planning have led to inefficiencies. These are opportunities for cost cutting. We have examined different approaches to cost reduction, from re-engineering processes and the greater use of technology through to major departmental change programmes. The NAO is therefore well-placed to set out its expectations of the effective management of cost reduction.
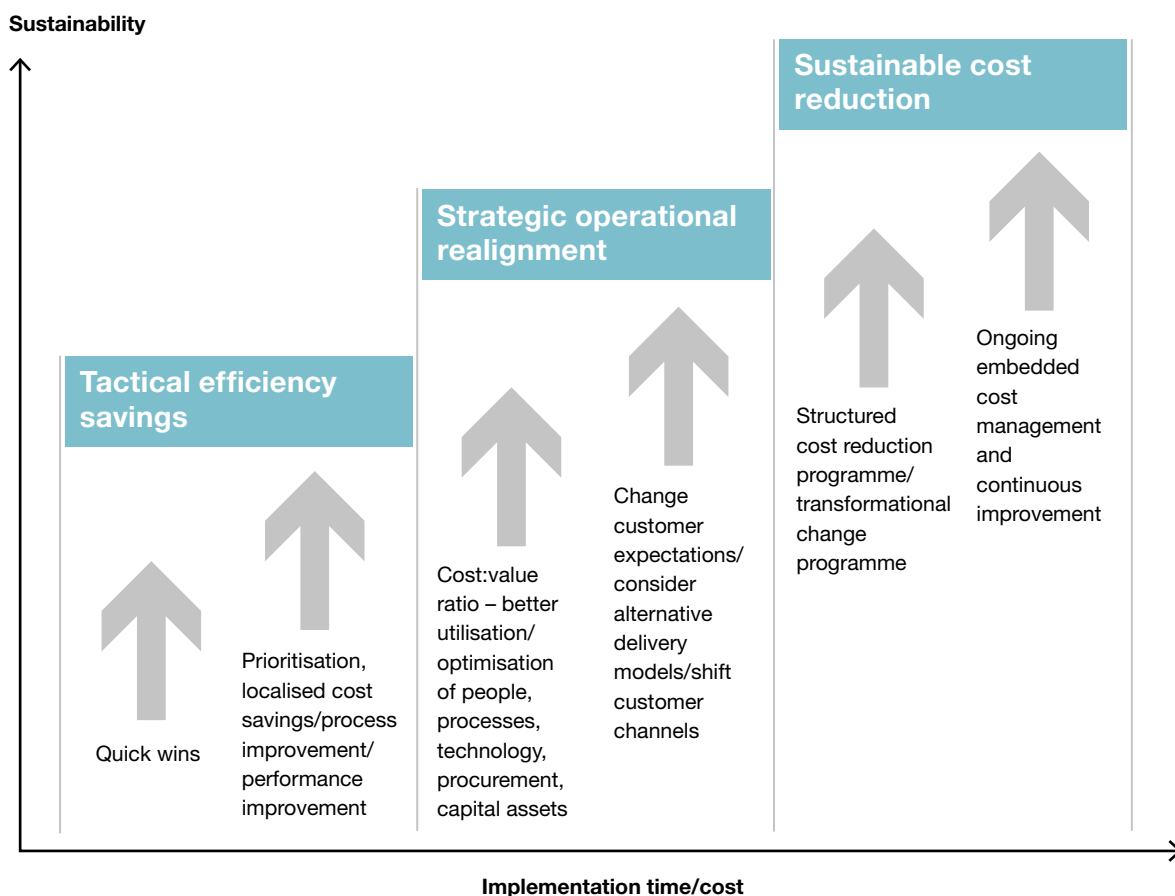
Structured cost reduction

The Government has stated that reducing the budget deficit is its most urgent priority. In May 2010 it announced a £6.2 billion reduction in spending in 2010-11 by cutting waste and low value programmes, and committed to further reductions through a Spending Review to follow later in the year. To meet this challenge, departments must look beyond immediate **short-term 'efficiencies'** and think more radically about how to take cost out of the business long term. Uniform top-slicing of budgets or indiscriminate cost-cutting can leave organisations exposed and unprepared for the future and can lead to higher overall costs or the displacement of costs elsewhere.

Cutting spending effectively requires departments to take a strategic overview to avoid an erosion of service quality in priority delivery areas. Departments should clearly prioritise what matters most, based on an accurate, realistic assessment of the costs, benefits and risks of the options. This involves consideration between different programmes and **programme slimming** to evaluate each element of a programme to identify those elements that are costly but make less of a contribution to programme effectiveness. Then, tactical efficiency savings can be made to 'trim the fat'. These are often highly visible and signal intent and implementing these can allow time for a more strategic realignment within a longer-term **structured cost reduction** strategy.

Addressing a department's cost base more fundamentally (see below) could save significant sums in the medium to long term but could require upfront spending. This may be hard to justify at a time of fiscal constraint but the longer-term return on investment should be considered to allow departments to be bolder in their approach. Departments could also explore the use of alternative financial models without the commitment of upfront investment; more flexible payment options could be aligned with the achievement of cost savings.

Stages of cost reduction

Sustainability

Tactical efficiency savings

Quick wins

Prioritisation, localised cost savings/process improvement/ performance improvement

Strategic operational realignment

Cost:value ratio – better utilisation/ optimisation of people, processes, technology, procurement, capital assets

Change customer expectations/ consider alternative delivery models/shift customer channels

Sustainable cost reduction

Structured cost reduction programme/ transformational change programme

Ongoing embedded cost management and continuous improvement

Implementation time/cost

The long-term aim should be for departments to heighten their competence in cost management and to be continually challenging the cost base, monitoring the relationship of costs incurred to outcomes achieved, and aspiring to create an environment for continuous improvement. This is important when managing business as usual activities and ongoing projects, but should also be considered at the policy design stage and when planning new initiatives. Working in new ways often leads to suggestions for further improvement as people become familiar with a new approach but this requires sustained impetus from the leadership in actively demonstrating commitment to ongoing improvement.

To achieve the goal of structured cost reduction, we expect departments to demonstrate the following principles:

● A data-driven approach to understanding, comparing and interrogating costs

Departments should have a good understanding of the distribution and profile of costs in their business. They should understand the pattern of resources in the business – policy, administration, capital programmes, grant and support giving, and service delivery. This will help identify opportunities for cost reduction but also help improve ongoing financial management. Often departments do not have a good grip on the costs of their activities, and it is rare to see good information on the unit costs of outputs. Without this, departments cannot make rational choices about what to stop, what to change, and what to continue.

● A change in organisational culture

The challenge of structured cost reduction requires organisations to question how they have always done things, and to be bold in developing alternative ways of doing business. Departments should look beyond traditional organisational boundaries and take a system view in order to maximise the opportunities to operate more efficiently across delivery networks.

● An analytical framework for assessing opportunities to reduce costs – understanding cost levers

It is also essential to understand the drivers of cost, including the supply side levers (people, processes, technology, procurement, capital assets) and how to influence demand (activity levels, changing customer expectations, smoothing demand patterns).

Departments should use an analytical framework, with both quantitative and qualitative factors, to assess how to influence cost drivers for an optimal result. This should include consideration of alternative delivery models, such as outsourcing rather than maintaining in-house capability, or centralising instead of delivering locally. The framework should also take a system view, as cutting costs in one area could result in increased costs elsewhere, particularly when delivery takes place through a complex network of different organisations.

Departments must of course take account of constraints, such as the minimum levels of provision necessary or legal requirements that require compliance. They should also use comparative data from similar services or organisations to understand the likely range of costs and where they could obtain greater value for money. Benchmarking costs also reveals opportunities for collaboration and greater standardisation.

● An analysis of the cost:value ratio

An understanding of costs (inputs) should be linked to an understanding of value (outputs and outcomes); departments should seek to maximise this relationship. The concept of value should drive the organisation's strategic objectives and inform its cost reduction strategy. This will avoid inadvertent cuts to high-value, low-cost services.

● A comprehensive risk assessment

Different approaches to reducing costs carry varying levels of risk. A major change programme may require significant capital investment and reconfiguration but with high risks attached; the improvement of existing business processes will have a lower risk profile.

● A robust evidence-based cost reduction strategy

Implementing a cost reduction strategy should follow the principles of the core management cycle for all public service delivery (see opposite), including clear objectives of what the cost reduction strategy is expected to deliver and a clear plan to migrate from the current state to the new operating model.

Accountability

Boards should hold senior management accountable for strategic choices, for implementing the chosen cost reduction strategy within an effective control environment and, ultimately, for delivering results. Departments should manage relationships and provide the necessary oversight of delivery partners to ensure cost reductions are achieved throughout the system.

A focus on realisation

All cost reduction programmes must focus on realising the savings through identifying, quantifying, delivering and measuring the real cost reductions. Departments should also take account of the cost of the approach, including staff time, IT infrastructure, severance programmes or initial training required, as this will determine the true cost savings and will be a significant factor in our audits of cost reduction activity.

A business as usual approach to cost reduction

Cost reduction programmes should not just be undertaken in response to budgetary constraints but should be built into business as usual, with ideas for cost reduction and continuous improvement encouraged, tested, implemented and evaluated on an ongoing basis. Staff should be assessed and incentivised to identify and implement strategies for long-term value for money. Cost management, regular benchmarking, and the adoption of wider good practice should be part of the core business and sustained by strong leadership and good quality information.
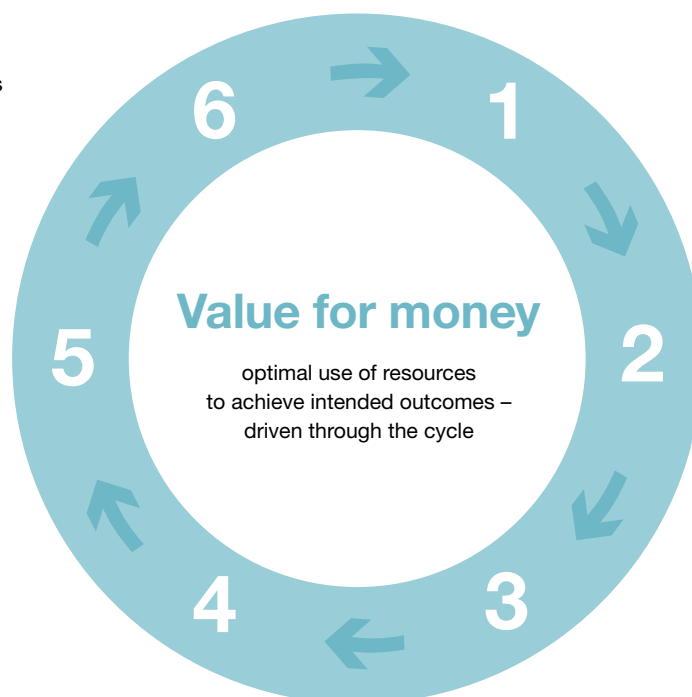
Core management cycle

6 Feedback
amends priorities and informs future strategy and planning

5 Evaluation
of implementation against strategic goals

4 Measurement
of quality, delivery, costs and user experience against benchmarks and targets

Value for money

optimal use of resources to achieve intended outcomes – driven through the cycle

1 Strategy
based on evidence with clear policy goals

2 Planning
with agreed priorities, resources, management information and programme management in place

3 Implementation
with good financial management, risk management, governance and controls in place

Examples from NAO reports

The following examples from NAO reports illustrate various approaches to cost reduction, as set out on page 3, from short term cost savings to better utilisation of resources or assets. The current fiscal challenges will require departments to think about the full spectrum of cost reduction opportunities and how to adopt a structured approach to cost reduction that will transform the organisation and embed cost control within business as usual. Our future programme of work will include a focus on how departments have risen to the challenge.

Centralising procurement led to significant cost savings

An IT system introduced to reduce costs and increase performance actually increased costs and delivered no improvement in accuracy

The procurement of goods and services by HM Prison Service (HC 943 2008-09)

In 2003 an NAO report concluded that the Prison Service's procurement function was "fragmented and costly to deliver" mainly due to the unclear responsibilities within prisons, the significant differences in the cost of procurement between similar prisons, and the lack of an integrated IT platform to support procurement decisions within the Prison Service.

In 2004, the Prison Service implemented a new strategy centralising its procurement function. This has led to cost reductions in both the number of procurement staff required and savings on its actual procurement activity. Overall, the main results of the report show that understanding costs leads to better performance. The report found that by operating a centrally controlled system, savings of £83 million were achieved between 2003-4 and 2006-7, whilst a further £37.5 million were estimated for 2007-8. It reduced the procurement staff costs by 38 per cent between 2003-04 and 2007-08. A new Procurement Strategy for the Ministry of Justice, which is based on the model deployed throughout the Prison Service, introduces changes that are forecast to generate savings of £140 million by April 2011.

A Second Progress Update on the Administration of the Single Payment Scheme by The Rural Payments Agency (HC 880 2008-09)

The Single Payment Scheme was introduced to the EU in 2005 to replace multiple subsidies for different categories previously paid to farmers. Payments to farmers in the UK came to £1.63 billion in 2008. In October 2009 the NAO discovered that implementation and development costs of the scheme's IT systems had amounted to nearly £350 million. The Rural Payments Agency has spent £84 million on 100 full-time consultants over two years, against a forecast spend of £36 million. The average cost of these contractors was over £200,000 per person in 2008-09. Heavy customisation of the IT systems resulted in very complex software which was expensive to modify and maintain, and has increased the risk of obsolescence. Despite changes that had taken place, scheme payments showed little sign of increased accuracy, with estimated overpayments of £24.3 million and underpayments of £38.8 million in scheme year 2008.

Immediate cost savings resulted in an increase in total cost and delays in delivery

Ministry of Defence: Major Projects Report 2009 (HC 85I & HC 85II 2009-10)

The Major Projects Report 2009 details the cost, time and performance of 30 military equipment projects from across the Ministry of Defence. Two-thirds of the gross cost increases reported reflected deliberate decisions to slip projects. As part of a wider package designed to address a gap between estimated funding and the cost of the defence budget over the next ten years, the department made a deliberate corporate decision to slow the rate of manufacture in order to reduce forecast expenditure by £450 million in the next four years. The decision causes the entry into service of the first aircraft carrier to slip by one year and the second by two years. This has increased the average annual spend by £187 million in the next 6 years, giving a net increase in costs of £674 million. Although necessary to ensure the affordability of the programme in the near term, the obtaining of a spending deferral in the first four years has resulted in delayed delivery and an up to 16 per cent increase in the total cost of the procurement.

Variances in prices paid and average rents highlight opportunities for better utilisation of government property

Improving the efficiency of central government's office property (HC 8 2007-08)

The government civil property estate was estimated to cost £6 billion to run annually in 2006. NAO analysis found that there is a large range in the prices paid for government accommodation per person and per square metre of space. Average rents also differ greatly between Government Office regions, from £397 in London to £63 in the South West. By undertaking a strategic approach to property asset management and bringing the performance of buildings into line with the private sector, gross annual expenditure on offices would be reduced by £326 million. Relocating to a cheaper region would lead to further savings.

Many departments do not have an accurate understanding of their office buildings and the utilisation of the people who work there, nor do they have strategic property asset management plans for their whole department family. The NAO's work showed that if departments can collect better data and engage with the OGC's High Performing Property benchmarking service they would be in a suitable position to achieve cost savings.

Where to find out more

Further reading

The National Audit Office website is
www.nao.org.uk

If you would like to know more about the NAO's work and how we can help public bodies to improve performance, please contact your NAO client lead in the first instance or contact us via our general enquiries desk on:

020 7798 7264
enquiries@nao.gsi.gov.uk

Alternatively you can contact Marcial Boo, our Director of Strategy, Knowledge and Communications, who can then put you in touch with the most appropriate person within the NAO.

marcial.boo@nao.gsi.gov.uk

Further guidance, tools, technical information and good practice can be found on our website:

www.nao.org.uk/guidance__good_practice.aspx

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