REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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Reducing costs in the Department for Transport

Key facts

£12.8bn

the Department for Transport's budget in 2010-11, the baseline year for the spending review

15%

the reduction, in real-terms, in transport spending by 2014-15 when compared with the 2010-11 baseline

68%

the proportion of the Department's 2010-11 budget spent through third parties[1]

£3.4 billion	the amount of the Department's budget in 2010-11 spent on rail
£3.2 billion	the amount of the Department's budget in 2010-11 spent through the Highways Agency, an Executive Agency of the Department
£2.7 billion	the amount of the Department's budget in 2010-11 spent via Transport for London
£2.6 billion	the amount of the Department's budget in 2010-11 spent through local authorities
£683 million	the budget reduction in 2010-11, as a result of the 2010 emergency budget, before any spending review budget reductions
2 per cent	contingency budgets as a proportion of the Department's total budgets (2011-12 to 2014-15)

1 'Third parties' do not include Executive Agencies.

Summary

1 Reducing the budget deficit is a Government priority. The 2010 spending review announced significant spending reductions across Government. The settlement for the Department for Transport (the Department) provides a budget that is 15 per cent lower in real terms than the baseline of £12.8 billion in 2010-11. This is in addition to an earlier £683 million reduction the Department committed to in the 2010 emergency budget which was already incorporated in the baseline for the spending review. To live within this settlement, the Department has reduced spending plans across all areas of its business.

2 The Department provides leadership across the transport sector. Its primary objectives are to support economic growth and reduce carbon emissions. The Department works with local and private sector partners to deliver many of its services and funds major road and rail infrastructure projects. Spending decisions in transport often result in long-term commitments, and at any point in time, the Department has spending commitments resulting from earlier investment decisions. This can make it difficult to vary spending plans at short notice.

3 This report sets out the Department for Transport's cost reduction plans (Part One), how the Department identified and assessed cost reduction measures (Part Two), and its progress in implementing them (Part Three). Appendix One summarises our audit methodology.

4 In November 2011, the Government announced additional transport spending in its Autumn Statement, which is not covered further in this report. This amounted to £1.7 billion of new spending on transport infrastructure over 2011-12 to 2014-15, and a further £950 million of improvements to the rail network financed through Network Rail. In addition, there is a £345 million expense associated with keeping the cap on passenger rail fare increases at 1 per cent above inflation in 2012 (it was previously due to rise to 3 per cent above inflation).

Key findings

Reducing costs within a broader vision of strategic change

5 To achieve large scale sustainable cost reductions it is important to have a clear plan of how an organisation will work in the future given its vision and objectives. This is known as a target operating model. The plan should be refined regularly as analysis of information develops. By analysing the cost and value of activities and comparing these to the model, an organisation can then start to prioritise resource allocation.

6 **As early as 2009, the Department recognised the need to rethink how it would deliver its objectives more cost-effectively, in the longer term.** Before the spending review, the Department embarked on a number of initiatives aimed at making sustainable savings. It also undertook projects to examine how it could do things 'fundamentally differently' in specific areas. These initiatives were not generally expected to produce short-term savings but this early thinking helped to identify some areas for reducing budgets during the spending review.

7 **The Department did not have a target operating model at the time of the spending review.** This was because key elements of the above initiatives were not due to report until after the spending review and were aimed at influencing spending beyond 2014-15. Nor were these initiatives a holistic examination of the whole department and how it delivered its objectives. This meant that the Department did not have a long-term plan against which to make shorter-term decisions for the spending review period up to 2014-15. The Department used the spending review to identify areas where it needed to consider further reforms, announcing a strategic review of the Highways Agency, and has now started work to develop a more comprehensive approach to longer-term planning.

8 The spending review required the Department to find savings that could be delivered by 2014-15. In preparation, the Department conducted a case-by-case review of the impact of short-term cost reduction options, informed by its high-level objectives at the time. We found evidence that the Department used these to guide decisions on where to make cuts or where to protect spending, for example, protecting road maintenance, or highlighting the effect of capital and resource spending cuts on reducing carbon emissions.

9 The Department felt constrained in altering some areas of spending. A key decision was to exclude from consideration £10.7 billion expenditure (28 per cent of the Department's budget) on the Network Rail grant over 2011-12 to 2013-14, with the exception of negotiating a £150 million rebate. This grant is determined for a five-year period, running up to 2013-14. While it can theoretically be reopened, this is a lengthy process with no guarantee of reducing the Department's spending. This and other constraints limited the scope for judgements on the balance between different modes of transport. Instead, the Department committed to making savings of £298 million from the Network Rail grant in 2014-15 and is developing its proposals on delivering a sustainable railway. Excluding the Network Rail grant did not require compensating savings in other areas of the transport budget.

Understanding costs and values

10 To identify and prioritise cost reductions departments need a detailed knowledge of where costs are incurred, the factors driving costs, and the value of activities. Departments should understand the distribution of costs and the links between choices about what to stop, what to change and what to continue. Without this information, cost reductions are less likely to lead to sustainable savings.

11 The Department followed a structured process to identify potential areas for budget reductions. It had a good understanding of costs and values in some areas. Its understanding was limited in others:

- The Department had a generally good understanding of the relationships between costs and benefits on specific transport projects, such as Crossrail and national roads schemes, because it had economic appraisals to test various options for reductions.
- The Department commissioned a bespoke analysis of the relative benefits and costs of national highways maintenance, as information here was weaker (as previously identified in our 2009 report on *Contracting for Highways Maintenance*).
- Apart from specific stand alone schemes, the Department had more limited information on its spending through third parties:
  - For its block grants to Transport for London and local authorities, the Department commissioned work that helped to indicate broadly the costs and benefits of devolved spending.
  - The Department's understanding of the relationship between cost and value was weakest in rail, where there was no analysis of the relative benefits and costs of reductions in the scope of rail franchises or increases in passenger rail fares. There was also limited evidence on the potential for efficiencies by Network Rail from 2014-15, and no analysis on the potential efficiency savings prior to this as the Department and the Treasury excluded the current Network Rail grant from the spending review. A lack of transparency on Network Rail's costs is consistent with our past reports on the Department and the Office of Rail Regulation.

12 Using a sample of 73 per cent of the Department's budget we compared the spending review settlement to its spending plans for 2011-12 to 2014-15 that existed in June 2010. **We found that over half of the reductions are the result of cuts or deferrals to new investment and higher fares, rather than new approaches to delivering the same for less. One fifth of the reductions come from efficiencies.** Continuing to meet its objectives (for example, for its road schemes to support economic growth, relieve congestion and improve safety) within lower budgets will depend on the Department finding new ways to deliver them.

13 At the time of the spending review decisions, it was uncertain whether budget reductions in road maintenance and rail were financially sustainable. Budget reductions of £1,229 million will be made to national and local road maintenance. This includes £435 million from reducing road condition standards and cutting routine maintenance and unspecified efficiencies of £223 million, risking a deterioration in road quality and higher long-term costs to the Department or local authorities. The Department is also estimating £298 million efficiencies to the Network Rail grant in 2014-15, which depends on the outcome of negotiations on the next five-year rail settlement. The Department is now taking action to identify efficiency savings, including supporting local authorities to identify sustainable budget reductions in road maintenance.

Delivering cost reductions

14 Departments must have effective oversight of cost reduction measures, and their impact on achieving objectives, to reduce costs sustainably. Risks to budgets and objectives should be monitored in an integrated way. Contingency plans need to allow for the likelihood that not all cost reduction measures will be successful, and new risks may materialise.

15 The Department's monitoring of cost reduction measures does not provide a strategic overview of whether transport spending is becoming more cost-effective, in particular because financial and performance reporting is not fully integrated. The Department has detailed information on individual cost reduction measures that the central department is delivering but its monitoring of cost reductions by third parties is more light touch, and varies according to control and oversight arrangements. The Department improved its oversight of Transport for London's infrastructure investment. In other respects, the Department does not have regular progress reports on cost reduction by Transport for London or local authorities, or on the risks that cutting costs places on delivering the Department's objectives. High-level monitoring does not quantify overall progress. Nor does it join up information on the cost and impact of budget reductions, and the links to objectives are not clearly stated.

16 One year after the spending review, it is too early to assess with confidence progress on the major cost reduction measures. The Department's assessment is that it is on track for delivering nearly all of the cost reduction measures it is responsible for. We have not validated this assessment, as most of the critical milestones against which progress can be judged lie ahead.

17 There are a range of risks to the Department's spending plans which could result in expenditure being higher or lower than expected. One area of immediate risk relates to rail franchises, where the Department is exposed to variations both in rail revenues, which have historically proved difficult to forecast accurately, and to commercial negotiations with Train Operating Companies. The Department also recognises that it potentially faces significant financial risk from higher than expected inflation. Where the Department gives cash grants to local authorities and Transport for London, inflation risk is passed on through their budgets, but this could still impact on the Department achieving its local transport objectives. For other areas of the Department, shortfalls could require further reductions to budget lines unless other funds become available. Fluctuations in budgets present risks to value for money, for example, £237 million of efficiency savings at the Highways Agency are based on better contracting, of which a key part is certainty of funding. We believe that long lead times for infrastructure projects also limit the Department's flexibility to respond to changes in funding by accelerating or delaying projects.

Conclusion on value for money

18 The Department did well to start preparations for the spending review early and to take steps to improve and challenge the evidence on which it based its decisions, with a view to securing value for money. This was done in a short timescale and with limited flexibility over key areas of spending. At the time of the spending review, the Department had elements of a strategic vision but there was no comprehensive strategy for prioritising resources based on a full understanding of costs and value. Without this we believe the Department cannot guarantee that its decisions will achieve value for money.

19 In terms of the decisions it took to reduce costs, there are risks to value for money: reductions to road maintenance may not be sustainable without deterioration in asset quality; and reductions in rail budgets depend on successful negotiations with third parties. Securing value for money in future depends on the Department's ongoing work to develop a longer-term approach to transport planning, and to consider further reforms to allow the transport system to operate effectively at lower levels of funding.

Recommendations

20 Our recommendations are designed to help the Department secure value for money in achieving its cost reduction commitments. The recommendations also aim to help the Department better understand costs and benefits across its whole business, as it considers longer-term plans for delivering its objectives at a lower and more sustainable cost.

Reducing costs within a broader vision of strategic change

a **The Department's plans for cost reduction during the spending review period were based on a pragmatic bottom-up examination of spending to identify options within identified constraints.** The Department should continue its work to take a more holistic view of the whole Department and how it might deliver its objectives at a lower cost, considering issues such as the balance between:

- investment and maintaining transport infrastructure; and
- different modes of transport.

b **For the first three years of the spending review period, the Department could only seek savings from Network Rail by negotiation, even though it accounted for £10.7 billion of the Department's budgets.** In its response to the McNulty review, the Department should seek:

- more transparency over Network Rail's costs and outputs; and
- more flexible mechanisms for returning savings to the Department within a five year funding period.

Understanding costs and values

c **Initially, the Department had limited knowledge of whether the spending devolved to Transport for London and local authorities (the latter for maintenance) was cost-effective.** The Department should build on its good work to understand these areas of spending during the spending review. It should work with these bodies to develop measures for them to report against, both to the Department and to the public for greater transparency to give assurance that taxpayers' money is being spent well.

d **Reducing maintenance may lead to a deterioration in road quality and so increase costs in the longer term.** The Department needs to monitor closely the condition of national and local roads, compared with the minimum condition needed to meet its objectives and avoid incurring future costs. This should be combined with regular progress reports on actual efficiency savings achieved.

Delivering cost reductions

e **The Department's monitoring of cost reduction measures does not provide a strategic overview of whether transport spending is becoming more cost-effective.** As the Department develops its vision of a lower-cost operating model, it should put in place performance measures which give:

- a quantified assessment of progress on individual and overall budget reductions;
- a clear link between all spending lines and objectives; and
- joined-up reporting of budget reductions and their impact on long-term value.

f **We welcome the Department's investment in working with local authorities to identify and share how efficiencies can be made in maintenance.** This good practice needs to be applied to other areas of spending with third parties, so that the Department knows how cost reductions are being achieved, the impact on quality and whether its objectives are being met.

g **The Department has identified that there are risks to the delivery of cost reduction from higher inflation and fluctuations in subsidies to train operators.** The Department should continue to develop this work to:

- quantify the potential impact on different budgets and objectives, across its whole business and for a range of scenarios of both higher costs and fluctuations in income;
- understand the relationship between cost and value in areas of potential further reduction or additional spend; and
- develop plans to minimise any impact on budgets.