

Ofwat budget planning and forecasting process – lessons learned report

Background to this report

1. Ofwat's Audit Committee, main Board and Executive Team have devoted significant attention during 2013-14 to learning lessons from the need, mid-way through the financial year, to increase Ofwat's 2013-14 budget and budget forecast for 2014-15.
2. Ofwat's original 2013-14 budget had been developed by the Executive Team on the basis of including costs where there was a high degree of probability that they would arise, in the expectation of an amount of additional flexibility to meet risk-based contingencies associated with unspent licence fees accumulated in previous years. The expectation was that this flexibility would be sufficient to deal with any uncertain costs not covered within the original budget. However, the scale of the increase required – £5.6 million (from £21.5 million to £27.1 million) – exceeded the level of permitted flexibility. The increased budget was needed to address an under-estimate of the organisation's budget to meet the full delivery costs of the 2014 price review alongside its other commitments.
3. When announcing the additional funding requirement on 25 July 2013, Ofwat committed to carefully review, through its Audit Committee and Board, how the full resource requirements were not forecast earlier in the budgeting and planning cycle and identify lessons to improve future forecasting and budgeting. This report sets out the findings of the organisation's review.
4. The most significant and immediate cost pressures for 2013-14 related to delivering the 2014 price review. In part, the under-estimate reflected a long-term challenge of finalising very significant policy change through the new price setting methodology with a robust delivery plan, approach and costings. Finalising Ofwat's approach to delivering the price review involved very significant changes in how customers' prices are set and so involved extensive stakeholder consultation in the first half of 2013. The timing of this process did not align with the budgetary cycle, meaning that the total costs of delivering the new methodology were not fully understood at the time the 2013-14 budget had to be set.

5. The shortfall for 2013-14 was bridged through a combination of a special licence fee of £3.2 million, and drawing down an additional £2.4 million, which was the value of the permitted flexibility associated with accumulated unspent licence fees from previous years. For 2014-15, a licence modification has been agreed with the sector which has the effect of increasing the licence fee cap using the provisions of section 13 of the Water Industry Act 1991.
6. The findings and recommendations of the lessons learned exercise were discussed by the organisation's Audit Committee on two occasions (in September and November 2013), and full Board in December 2013.
7. Publication of this report reflects the commitment of the organisation to learn lessons from the issues which emerged, and to be transparent in sharing both the lessons learned and the actions taken as a result of the events set out in this report.
8. The scope of the report is limited to the corporate budget setting process for 2013-14. Wider lessons to be learned from the price review, including its process, programme and outcomes, will be considered once the 2014 price review has concluded. In particular, this will consider the challenge of translating the future price limits principles, published in spring 2012, into a detailed price setting methodology, budget and delivery model.
9. The lessons learned exercise concluded that:
 - a. while the usual business planning and forecasting processes had been followed, they had not worked effectively in forecasting the implementation costs of the 2014 price review; and
 - b. there were multiple causes of the issues, which centred on programme management, information, skills shortages, and financial culture, control and accountability.
10. A detailed action plan has been developed to address the root causes which the review identified. Significant progress has already been made implementing those recommendations, which Ofwat's Audit Committee continues to monitor. The recommendations of the lessons learned review, and progress implementing them, are set out in detail in appendix 1.

How the full resource requirements were not forecast earlier in the budgeting and planning cycle

The business planning and budget setting processes for 2013-14 followed a similar process to previous financial years, which had been characterised by a pattern of under-spending against budget. As with previous years, the budget was prepared on the basis of very high probability costs in the expectation that flexibility associated with unspent licence fees in previous years would be sufficient to deal with cost uncertainty. After consultation with project teams and Executive Team review, in February 2013, Ofwat's Board approved a £21.5 million budget for 2013-14. This included £5.6 million for external consultancy and legal support.

However, while the normal processes had been followed, they clearly failed to work effectively. Subsequently, from February 2013, a debate evolved within the Price Review Team about the desirability of using a Delivery Partner to support the implementation phase of the price review by providing advice, analysis and assurance. Given the cyclical nature of the price setting process, the significant peaks of demand that arise during its most intensive phases, and difficulties finding suitable candidates to fill critical roles, a model using a single Delivery Partner offered significant flexibility and a cost-effective means of delivering the price review.

By April 2013, it was clear that there were serious budget pressures, and by May the Price Review Project Board and full Board had discussed a proposal that a Delivery Partner should be used. It was not possible to fully scope the work for the Delivery Partner until the design of the risk-based review had been finalised, which was confirmed in the final methodology statement of 25 July 2013.

A tendering process for a Delivery Partner began in June 2013, with bids received in July 2013. For reasons including the scope of the work required, the bids submitted were not affordable within Ofwat's original 2013-14 budget, and exceeded the levels of accumulated reserves from previous years' licence fees. In August, following negotiations with Delivery Partner bidders and parallel negotiations with the Treasury, which approved the award of the Delivery Partner contract, Ofwat's Board approved a revised 2013-14 budget of £27.1 million.

Lessons to improve future forecasting and budgeting

The major causes of the planning/forecasting difficulties were as follows.

- **Project, programme and risk management.** The budget forecasting issues reflect a need to improve corporate operational processes, particularly delivery management systems. This requires both systematic and cultural changes. The organisation will need better programme and project management approaches for all significant pieces of work, including formal change protocols. Risk management techniques and practices will need to be applied more consistently and the alignment between budgeting and programme management improved. Finally, the organisation will need a strong, capable and empowered finance function to provide horizontal challenge and scrutiny across projects.
- **Focus on policy.** Delays arising from the process of modifying companies' licences in line with the new methodology, uncertainty about what was being proposed until the methodology and approach to the risk-based review had been finalised, and the need to engage external stakeholders about the new approach, meant that the organisation's focus was inevitably on policy issues at the expense of effective implementation planning. This reflects wider cultural issues, including staff training, effective leadership and capacity, particularly the absence of sufficient, experienced programme management capacity below the Executive Team.
- **Management information.** The quality of information available to the Project Board and main Board needed to be improved. Budget papers for Board and the Executive now benefit from significantly greater detail, particularly on assumptions, to support effective scrutiny and challenge.
- **Skills shortages.** Shortages of the necessary skills and capacity, both within the price review and wider organisation, contributed to the planning and forecasting difficulties. In particular:

- The price review project had a clearly defined ‘Programme Director’ role, which at this time was filled by an interim working on a part-time basis. This role focused predominantly on delivering the methodology against a continuously difficult timetable. Compounded by wider skills gaps within the organisation, this led to a lack of sufficient capacity both to deliver the complexity of the methodology and plan the next 18-24 months of the programme. While the existence of the organisation’s skills gap was acknowledged, the reality is that the problem was never adequately resolved.
- Despite determined and organised efforts to recruit Delivery Director level staff, there was a failure to fill all the senior roles known to be necessary for both the methodology and implementation phases of the price review. Consequently, a number of specialist interim contractors filled these gaps, which led to a mix of internal and external resources which we would not have chosen for this key project. There is a general acceptance that while a recent reorganisation significantly addressed historic imbalances in Ofwat’s skill mix, a further need remains to develop a richer internal skill mix. Ofwat has developed a People Strategy, which will help us improve recruitment and address the challenges highlighted in this report.
- **Financial management.** There was insufficient clarity about accountability for each budget line, reflecting a centralised approach to budget management. Poor links between the Finance Team and key programmes compounded this lack of accountability, which meant that forecasting, monitoring and budget discussions, as well as early planning of procurement strategies, did not take place in a sufficiently timely manner to identify and address the key risks.

Recommendations and action plan

This report sets out a series of recommendations (appendix 1), which build on rapid operational changes in Ofwat’s financial and risk management. They were proposed by the Executive and discussed with and reviewed by the Audit Committee and Board. The specific actions are set out in appendix 1. Ofwat’s Audit Committee has monitored progress against these recommendations, and will continue to do so.

Appendix 1: Recommendations and action plan

Recommendation	Responsibility	Timescale	Progress (to the end of December 2013)
Theme 1 – improved monthly financial reporting to Board			
<p>In addition to the quarterly performance report, a more detailed monthly financial report should be produced for Board, which includes:</p> <ul style="list-style-type: none"> · year-end estimates for the total budget and each main budget line; · a more granular breakdown of each of the main budget lines; and · a financial risk and opportunity matrix. 	Bev Messinger/Rob Powell	From September 2013 Board meeting.	More detailed financial reports presented from September Board onwards.
Theme 2 – annual budget assumptions			
<p>The proposed annual budget paper setting the budget for the following financial year should contain a fuller set of the assumptions behind the figures, including risk-based contingency and the scenarios used for planning purposes, to allow both the Executive Team and the Board to review and challenge how the recommendations have been derived.</p>	Bev Messinger/Rob Powell	October 2013 to February 2014 meetings.	Indicative 2014-15 budget, and assumptions, including risk-based contingency, presented to December 2013 Board. Final budget paper for approval due for February 2014 Board.
Theme 3 – programme, project and risk management			

Recommendation	Responsibility	Timescale	Progress (to the end of December 2013)
<p>An annual report should be presented to Audit Committee which assesses the effectiveness of Ofwat’s delivery management systems.</p> <p>As part of wider organisational development work to improve significantly Ofwat’s delivery management systems, an operational plan should be introduced to enable much more rigorous forecasting of how all resources, both financial and staff time, will be deployed to programmes and in support of Ofwat’s strategic objectives. This should profile staff and external resources by month against the aggregate demand for resource in 2014-15 and should replace the previous system known as the ‘Gateway’ process, with Project Initiation Documents for new projects.</p> <p>Reflecting the results of a recent self-assessment against the Treasury’s Risk Management handbook, Ofwat’s risk management improvement plan should be implemented and should move Ofwat to the third level of maturity in the Treasury model by November 2014.</p>	<p>Bev Messinger/Rob Powell/Carolyn Baker</p>	<p>November 2013 and March 2014 Audit Committees.</p> <p>First operational plan to be in place by 1 April 2014.</p> <p>Risk management improvement plan to be implemented by November 2014, with an interim progress report to the June 2014 Audit Committee.</p>	<p>Paper presented to November 2013 Audit Committee, setting out proposed changes to our planning processes and our risk management improvement plan. Update scheduled for March 2014 Audit Committee.</p> <p>Operational plan development in train.</p> <p>Risk management improvement plan agreed by Audit Committee in November 2013.</p>

Recommendation	Responsibility	Timescale	Progress (to the end of December 2013)
Theme 4 – skills			
To address problems with recruitment of suitably skilled staff, we will implement separate actions within Ofwat’s People Plan to develop a co-ordinated and robust approach to resourcing in ‘professional services’ style, including improving our approach to staff and non-core recruitment, ensuring that we have slick processes that enable us to respond quickly and recruit effectively.	Bev Messinger/Justine Kenny	By June 2014.	Work under way to implement this recommendation by June 2014.
Theme 5 – change protocol			
A mandatory change protocol should be introduced for named major projects. This protocol needs to be developed to be suitable for the policy-style projects that dominate Ofwat’s main workload. The proposed protocol and the projects to which it applies should be the subject of recommendations to the March Audit Committee.	Bev Messinger/Rob Powell/Carolyn Baker	Change protocol, to be implemented from 1 April 2014 following March Audit Committee.	Work under way to develop change protocol to support the operational plan.
Theme 6 – clear accountability for each aspect of the budget			
New and more detailed accountabilities should be established for each major budget line (at Senior Responsible Officer and budget manager levels), coupled with mandatory training for all budget managers and	Rob Powell	August 2013 to March 2014.	Accountabilities clarified August 2013, and Senior Responsible Officers named in Board budget papers from

Recommendation	Responsibility	Timescale	Progress (to the end of December 2013)
<p>publication of budget management and procurement guidance covering the remainder of 2013-14 and 2014-15.</p>			<p>September 2013.</p> <p>Mandatory training sessions run in October and November 2013.</p> <p>Draft budget management and procurement guidance published for comment in October 2013 – final versions due for publication in January 2014.</p>
<p>Theme 7 – developing a stronger financial culture</p>			
<p>To embed the principles of Managing Public Money and a stronger culture of accountability, mandatory training should be provided for all budget managers. Budget managers should be supported through the stronger links with the Finance Team through new ‘Finance Partner’ roles.</p> <p>Financial leadership within Ofwat should be improved through appropriate deployment of senior staff with financial experience and qualifications.</p> <p>To embed financial leadership from the Executive Team, ensure that the Executive Team discusses resource issues in the round, including the monthly budget report, on a monthly basis.</p>	<p>Bev Messinger/Rob Powell</p>	<p>October 2013 to March 2014.</p>	<p>Mandatory training sessions run in October and November 2013.</p> <p>Financial team leadership and alignment with budget managers addressed August 2013.</p> <p>New Senior Director of Operations in post from December 2013.</p> <p>Executive Team monthly budget discussions from September 2013.</p>

Recommendation	Responsibility	Timescale	Progress (to the end of December 2013)
Theme 8 – improved communication and engagement between programme teams and the Finance Team			
<p>There is a clear need to strengthen the links between programme teams and the Finance Team. Finance Partner roles should be established to support each budget manager, who should be accountable for:</p> <ul style="list-style-type: none"> a) regularly communicating with the budget manager about budget setting, monitoring and forecasting; b) understanding programmes, projects and areas of spend so that budget managers are well supported; c) co-ordinating the provision of high-quality advice to budget managers and Senior Responsible Officers on procurement, contracts, budget setting, monitoring and forecasting; d) supporting the effective management of change in budget lines; and e) providing an effective link between the budget line and the overall process of setting, monitoring, forecasting and managing Ofwat’s budget. 	Rob Powell	Finance Partners created for each budget line – August 2013.	<p>Finance Partners in place from August 2013.</p> <p>Monthly meetings between Finance Partners and budget managers in place from September 2013.</p>



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January 2014

ISBN 978-1-908116-59-8

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