HFMA introductory guide to NHS finance

Chapter 17: Costing

Chapter 17: Costing

Overview

This chapter describes what costing is, how it is undertaken in the NHS, and how cost data is used.

17.1 Introduction

Understanding the cost of caring for patients is vitally important, both locally and nationally, when making decisions about how to manage and deliver sustainable high-quality services.

The *NHS long term plan*[239] aims to get the most value for patients out of every pound of taxpayers' investment. Robust and detailed cost data is vital for supporting this aim, allowing the NHS to understand service costs, reduce unwarranted variation and develop new models of care.

Good cost data can help NHS organisations and systems to understand variations in the way that patients are treated and the impact on available resources. When this information is linked to health outcome measures, the NHS can make value-based rather than volume-based decisions.

Providers of NHS services have increasingly large amounts of data about their service users and patients, with the roll-out of patient-level costing (PLICS) across the NHS. Cost data needs to be presented in a way that is clinically meaningful so that clinical teams are keen to work with finance teams to use the data to support service improvement.

Robust cost data is also vital for informing the payment system - the system of financial flows that moves money around the health service; see chapter 18 for more details.

17.2 What is costing?

Costing is the quantification, in financial terms, of the value of resources consumed in carrying out a particular activity or producing a certain unit of output.

Costing involves:

- being clear about the activity whose costs you are seeking to identify – it must be defined clearly and unambiguously
- making sure that the correct costs of everything and everyone involved in carrying out that activity are included in the costing calculation.

It is also important to analyse the costs themselves, how they are related to what is being costed and how they behave. We will look in more detail at these cost classifications later on in this chapter.

17.3 What is costing information used for?

In the NHS, costing involves looking closely at healthcare services and identifying how much they cost. This can be at a variety of levels – for example, the total annual cost of the orthopaedic department in a hospital, the cost of a particular activity or group of procedures within that department (for instance, hip replacements) or the cost of treating an individual patient undergoing a

[239] NHS, *The NHS long term plan*, January 2019

hip replacement. Patient pathways often cross organisational boundaries, and it is becoming increasingly important to understand costs at a system level.

The NHS needs costing information for a variety of reasons, including the following:

Informing value-based decisions

Robust cost data, linked with quality and outcome data, is fundamental to understanding and measuring value. Value is covered in more detail in chapter 18.

Improving efficiency and effectiveness

Costing provides clinical and operational teams with the evidence to ensure that resources are used in the most effective way possible to provide high-quality care and support the reduction in unwarranted variation. Both Getting It Right First Time (GIRFT) and the model health system (formerly the model hospital) use cost as well as other data to benchmark healthcare services.

Understanding patient pathways

Understanding how resources are allocated across a local health system (system costs) is key as the NHS moves to a more integrated approach to designing, planning and delivering services. Systems require cost and activity data describing the whole patient pathway across multiple services and organisations as they look to develop new models of care.

Developing payment systems

Cost data is used to inform national tariffs. Future payment systems will support the activities that create patient value and focus more on system costs than price.

17.4 Patient-level costing

NHS costing has gone through a significant transformation, moving from costing based on averages to costing the actual care individual patients receive. Reference costs were based on average cost per contact derived from total service cost, apportionment of overheads and annual activity. They have now been replaced by patient-level information and costing systems (PLICS) – otherwise known as patient-level costing.

Patient-level costing:

- brings together healthcare activity information with financial information in one place
- costs the actual care an individual patient receives
- provides detailed information about how resources are used at patient-level, for example, staff, drugs, diagnostic tests
- supports the measurement of value.

All acute, ambulance, community and mental health services are required by NHS England and NHS Improvement to calculate their costs at patient level.

PLICS can play a vital role in improving the efficiency and effectiveness of how patient care is delivered, bringing together information about the resources consumed by individual patients on a daily basis and combining this with the cost of the resource. When PLICS is analysed alongside other

performance and quality information it becomes even more powerful in understanding the delivery and performance of services. It also facilitates much more meaningful and constructive discussions with clinical teams.

17.5 The importance of high-quality data for costing

To generate reliable and robust cost information, costing accountants need access to high-quality data that describes the needs of the patients and the treatments received. At a patient level, this data may include the type of intervention, drugs prescribed for the patient, or consumable items used in their treatment. At an organisational level, this data may include information around estates costs, ancillary staff, or transport requirements. Even with the best costing processes in place, if the data from the clinical and operational feed systems is of poor quality, this will lead to inaccurate cost data.

17.6 Approved costing guidance

To ensure that costs are calculated on a consistent basis, NHS England and NHS Improvement issues annual *Approved costing guidance*[240] which sets out the costing standards to be used by providers of NHS services as well as collection guidance for submitting to the national cost collection.

Costing standards

The information requirement standard specifies the activity information and associated data fields required for patient-level costing.

The costing process standards cover the costing process from the general ledger to the patient unit cost and reconciliation to audited accounts.

The costing method standards cover the costing of high-volume and high-value areas, for example medical staffing.

The guidance explains the approach to costing and cost collection that should be followed and sets out what service providers will need to do in this area to meet the conditions of their provider licence.

Costing principles

NHS England and NHS Improvement's guidance sets out three principles which should underpin good costing processes in an organisation:

- materiality - costing effort should focus on high-value and high-volume services
- data and information – high-quality activity data must be combined with financial data to generate costs that reflect the actual care received by patients
- engagement and use– costing teams should actively engage with stakeholders to encourage the use of cost information to drive service efficiency and improvement.

17.7 Cost classifications

To improve the ability to analyse information, costs are classified in two ways:

- direct, indirect or an overhead – to examine how costs relate to an element of patient care
- fixed, semi-fixed or variable – to examine how costs behave and inform the way that they can be controlled.

[240] NHS, *Approved costing guidance 2022,* March 2022

Direct costs

Direct costs relate directly to the delivery of patient care and arise as a result of individual patient episodes of care. For example, within a hospital ward the cost of drugs supplied and consumed can be directly attributed to that ward by the pharmacy system. Hence, drugs would be a direct cost of the ward.

Indirect costs

Indirect costs are indirectly related to the delivery of patient care but cannot always be specifically identified to individual patients. Examples include catering and linen services.

Overheads

Overhead costs are the costs of support services that contribute to the general running of an organisation. These costs cannot be traced or easily attributed to patients and need to be allocated via an appropriate cost driver – something that causes a change in the level of costs. For example, the total heating costs of a hospital may be apportioned to individual departments using floor area or cubic capacity on the basis that the larger the floor area occupied by a department the greater the amount of heating used. The key here is that overheads are apportioned on a logical and consistent basis.

Fixed costs

Fixed costs are costs that do not change as activity changes over a 12-month period – for example, depreciation.

Semi-fixed costs

Semi-fixed costs are fixed for a given level of activity but change in steps as activity levels exceed or fall below these given levels. For example, additional nursing staff costs may be incurred when the number of patients being treated rises above a certain level.

Variable costs

Variable costs vary proportionately with changes in activity. In other words, they are directly affected by the number of patients treated or seen – for example, drugs and consumables costs.

NHS England and NHS Improvement's costing standards classify costs as:

Patient-facing costs

Those costs that relate directly to delivering patient care and are caused or driven by patient activity.

Overheads

Those costs that do not relate directly to delivering patient care but to running the organisation or services that support the delivery of patient care - for example, the finance department.

17.8 National cost collection

The national cost collection has three annual publications[241]:

- national schedule of NHS costs: these show the national average unit cost for each service

[241] NHS, *2019/20 national cost collection,* June 2021

- the national cost collection index (NCCI) measures the relative efficiency of NHS organisations from an index centred around 100. For example, an NCCI of 110 suggests a provider's costs are 10% above average; a score of 90 suggests they are 10% below average
- database of source data: this allows a more detailed analysis of organisation level costs.

Key learning points

- Costing involves quantifying the value of resources used to carry out an activity
- Costing is not an end in itself – it is used to help deliver improvements in healthcare services, and plays a key role in supporting the delivery of sustainable high-quality services
- Costing information has many uses at both organisational and national levels
- NHS England and NHS Improvement's approved costing guidance sets out the principles and standards that NHS organisations must follow when calculating patient-level costs. It also contains guidance on the national cost collection
- Costs are classified as direct, indirect or an overhead – here the focus is on how costs relate to an element of patient care
- Costs can also be viewed in relation to how they behave – as fixed, semi-fixed or variable
- A national cost collection index is published each year – this allows comparisons between NHS organisations

Additional HFMA resources

The HFMA maintains a directory of resources which provides links to other HFMA outputs such as briefings and webinars across a range of subjects, including a section dedicated to quality, costing and value. It also highlights e-learning courses that are available. The directory of resources can be found here.