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Breaking the risk barrier

How Payment by Results can be embedded in public sector programmes

Governments around the world are seeking ways to maximise the impact of their taxpayers' money. In the UK, policymakers and commissioners have started to focus on Payment by Results (PbR) to help reinforce the relationship between payment for public services and value received by the taxpayer.

In this paper, we explore the lessons commissioners and suppliers can learn from PbR's use in the public sector to date. Crucially, we consider the extent to which risk can be transferred to suppliers – and the challenges of successfully applying PbR in contract design.

Ultimately, we believe **4 key challenges must be overcome** to successfully transfer risk at scale. Only by articulating a clear vision, applying the right metrics, sharing meaningful data and creating an appetite for risk, can commissioners truly embed PbR in public sector programmes.

Understanding PbR

Public sector commissioners in the UK have been linking supplier payments to delivery for many years. For example, public-private partnerships and infrastructure programmes have well-established output-based arrangements where supplier payment is put at risk under a service credit regime, usually combining availability and performance measures. In the health sector, providers have been paid on outputs since 2003, with this approach credited with helping to significantly reduce waiting times while increasing the number of operations completed.

But PbR differs from these approaches, in that it links supplier payments to defined policy outcomes rather than inputs or outputs. In health for example, an input might be man-hours or equipment provided, and output may be the number of operations completed – but an outcome might be how many patients got better as a result.

Linking payments to results is both the main strength and weakness of PbR. On the one hand, it has the potential to transform how suppliers are rewarded.

On the other hand, establishing a single outcome or small number of clearly defined, measurable and representative outcomes that are capable of being influenced by suppliers is challenging. It may not always be achievable and doing so may have unintended consequences.

Experience of PbR to date

Despite the public sector's interest in PbR, its use has been limited, with the analysis somewhat mixed.

For instance, studies have indicated that PbR, particularly when applied to public services, has stimulated the market and enticed new providers.[1]

On the flipside, others have found that getting PbR right is not straightforward, due to the potential implications for service quality and value for money. For example, an NAO report found that the Work Programme had succeeded in lowering operating costs, but with no improvement in service delivery.[2]

Questions also continue to surround one of the primary drivers of PbR: outcome risk and the extent to which it can be transferred to suppliers.

Different approaches to outcome risk

The transfer of outcome risk has varied significantly in public sector PbR-based contracts to date. A good example of this is seen when comparing the Work Programme and Transforming Rehabilitation – two of the UK's heavily-championed PbR contracts.

While around 80 per cent of Work Programme supplier payments are linked to results, the figure for Transforming Rehabilitation is significantly lower at approximately 10 per cent.

> *"Such a good idea I want to put rocket boosters under it"*
>
> **David Cameron on Payment by Results**

1. 'Comparing Payment by Results across public services and in housing related support', Sitra, May 2013
2. 'Outcome-based payment schemes: government's use of Payment by Results', NAO, June 2015

Contracts such as the Work Programme – where a large proportion of the supplier costs are put at risk and are results-dependent – inevitably place a greater emphasis on outcomes among suppliers. When handled correctly, commissioners adopting this approach can create defined payment outcomes that cover all their desired results. Conversely, unintended and potentially damaging supplier behaviour can be created in cases when the defined outcomes do not fully represent complex policy objectives.

At the other end of the scale, introducing a small and managed element of PbR into a programme can incentivise suppliers to achieve payment outcomes, while recognising that other (perhaps less measurable) outcomes and aspects of service delivery are also desirable. This approach can recognise a supplier's limited ability to assume high levels of risk – for example if outcome payment mechanisms are lacking relevant historic performance data, if the value of a contract is disproportionate to a supplier's financial standing, or if a supplier's direct influence over the outcome is uncertain.

Ultimately, commissioners should remember that the extent to which payments are linked to outcomes will influence the attractiveness of a programme to the market, as well as supplier behaviour and pricing.

Successfully transferring risk at scale

While the success of the Work Programme is a matter of political opinion, the project certainly succeeded in transferring outcome risk to suppliers. So how has this programme managed to transfer risk at scale, by linking around 80 per cent of supplier payments to results, while other major initiatives like Transforming Rehabilitation have been more constrained?

Our experience of working with commissioners and suppliers suggests the following challenges must be overcome to apply PbR at scale:

1. Vision
Senior stakeholders and political leaders must articulate the policy's vision in a crisp and direct way

2. Metrics
Commissioners must be able to clearly define a small number of measurable and representative outcomes that reflect the policy vision

3. Data
Commissioners should hold meaningful historic performance data relating to volume drivers, target outcomes and – where possible – the influence suppliers might have over outcomes

4. Risk appetite
Regardless of the programme's design, providers must have an appetite for risk, based on an assessment of their ability to influence outcomes

Using PbR at scale

Vision

Using PbR at scale requires the policy's vision to be crisp and direct, driven by senior stakeholders.

The Work Programme had a clear and simple objective: to reduce the absolute number of long-term unemployed people. This allowed for the definition of a small number of representative outcome measures, which enabled the application of PbR at scale and with it the encouragement of certain supplier behaviours.

While Transforming Rehabilitation also had a clear policy vision – to reduce reoffending – the role of probation in society introduced additional complexity. Along with the complicated and long-term challenge of reducing recidivism, the role of the probation service includes public protection and the demands of multi-agency working for complex cases. Consequently, the use of PbR in this programme was much more constrained, at less than ten per cent.

The application of PbR as a payment mechanism is fundamentally dependent on a clear policy vision, while the application of PbR at scale is reliant on the simplicity of that vision.

Metrics

Payment metrics will directly influence supplier behaviour, and ultimately the success of a programme. The challenge for commissioners is to set outcomes, metrics and payment levels that encourage suppliers to apply the appropriate resources to achieve the desired policy objectives.

Set correctly, metrics will encourage desired outcomes to be achieved. But if set incorrectly, suppliers may apply inadequate levels of resource to achieving the objectives, or receive unnecessarily high remuneration for their effort.

There is a fundamental conflict between an objective of 'equal provision to clients' and the use of a PbR mechanism. Equal provision to clients is a valid political objective, but it is a measure of output, not outcomes. Programmes where the method or nature of delivery is of importance may not be well-suited to PbR mechanisms.

Critics of the Work Programme have accused some providers of 'creaming and parking' – prioritising easier-to-help clients over harder-to-help clients. But assuming this is true of providers, it would appear to be a critique of the political objective itself, and the focus on reducing the numbers of unemployed, rather than of equality of provision.

Alternatively, it could be a critique of the programme design, suggesting the different price levels applied to the defined payment groups inadequately reflected achievable performance or cost-to-serve.

As with any other financial incentive, if the value of the incentive is material it will drive very intentional behaviour to achieve metrics. It is therefore crucial that metrics are directly aligned to a comprehensive set of explicit objectives.

PbR payment metrics will drive behaviours in a very direct way, proportionate to the value of payments.

Accordingly, commissioners need to define a very small number of clear, measurable and representative metrics that encourage the right outcomes.

Data

The availability of meaningful historical data – with regards to both cause and effect – will heavily influence the extent to which PbR can be used in a contract.

The risk appetite of suppliers will directly correlate to the availability of meaningful data relating to what has already been achieved, and the ways in which their actions might influence future results.

"Harnessing the profit motive to desirable outcomes ... creates a greater flexibility of provision to allow tailoring and targeting of resources"

'Prison break: tackling recidivism, reducing costs', Social Market Foundation; Ian Mulheirn, Barney Gough and Verena Menne; March 2010

"Payment by Results does not reward organisations for supporting people to achieve what they need; it rewards organisations for producing data about targets"

Guardian Professional; Toby Lowe, Feb 2013

To use PbR at scale, the test for commissioners is in collating, and making available, relevant data for suppliers. Conversely, if commissioners are unable to do this, PbR will necessarily be more constrained, and suppliers could charge higher prices.

A history of contracted 'welfare to work' programmes gave a number of Work Programme bidders an accumulation of valuable data on which to base their proposals and pricing.

In contrast, despite a number of small-scale pilots focused on reducing reoffending, the first-generation outsourcing of probation services applied a much more constrained use of PbR to avoid undermining market appetite to bid. The broader objectives of the Transforming Rehabilitation programme could be met without such extensive use of PbR.

Just as historical datasets are important, the availability of reliable metrics through the life of the programme is also key. If used for payment, the accuracy, timeliness and transparency of a metric is critical. Otherwise, confidence that reported performance reflects reality and that valid performance will result in payment will be undermined, and the cost of unnecessary validation and rework will be high.

From a more strategic perspective, the collation of data through the life of a programme will then define an 'art of the possible' for future programmes. As a result, consideration of desirable data that is not currently available is arguably as important as the more immediate pressures of payment mechanism design. Addressing this will ensure commissioners are in a stronger position the next time they procure related services.

The visibility of data, both historical and through-life, will dictate market appetite, behaviours and administration costs.

Commissioners need to make this data available to suppliers, while ensuring it is as accurate and comprehensive as possible.

Risk appetite

Regardless of political commitment or project design, if the market does not have the appetite to bid for and deliver a programme, nothing will be achieved.

Market assessment of PbR programmes is challenging. The mechanism is new and relatively unproven. The market is often being asked to take on new risks that it has not previously been responsible for or, perhaps more accurately, has not been liable for.

Government providers have traditionally operated on relatively low margins. The income stream from government contracts has been relatively secure and the ability to grow scale through new contract awards has been the primary enabler of shareholder value. Furthermore, in traditional outsourcing, the primary risk for providers is the ability to transform the delivery model and cost base to match commitments made in the tender process.

In light of these issues, PbR regimes generate a novel set of challenges for providers:

- While focusing on the cost base of the inherited delivery model, they are also liable for ensuring that their activities support the achievement of results.
- Assuming that activities are delivered successfully and affordably, there is often a complex relationship between provider activity and the outcomes on which revenue is based. A range of external factors can override an otherwise successful provider performance, such as the economy and labour market dynamics for Work Programme providers.

"It takes time and effort to design PbR payment mechanisms that offer appropriate incentives to providers. If the payment offered is too high, the taxpayer could pay too much for the service; if too low, providers may not bid for the contract"

NAO press release: 'Outcome-based payment schemes: government's use of Payment by Results'; 19 June 2015

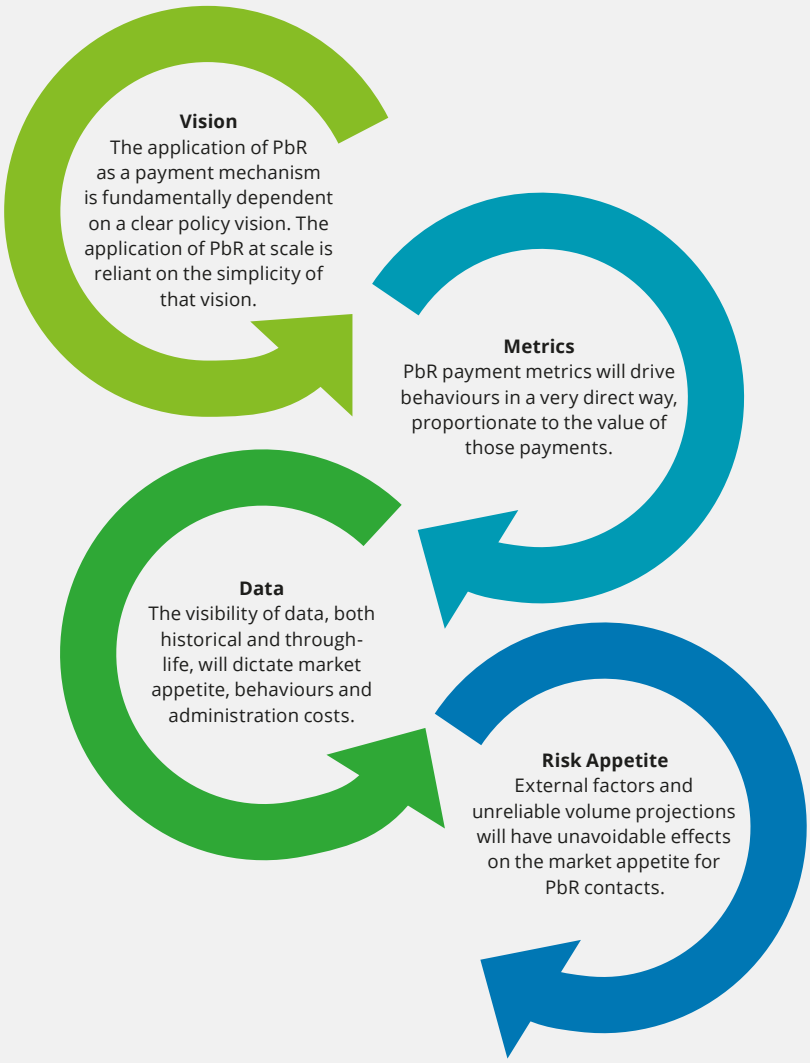
- Risk of addressable volumes is often an inherent part of PbR contracts. Projects are split between those where an external process definitively generates programme volumes, such as unemployment benefit claims or criminal offending, and those where providers must attract their own referrals from a particular target group. The latter is obviously riskier, but even programmes using the former have regularly suffered from inaccurate volume forecasts. If volumes turn out to be higher, operational delivery may suffer because providers have insufficient capacity to appropriately service their referrals. If volumes come in lower, providers' ability to recover fixed costs through PbR revenue is immediately limited, and the economics of a programme can be fundamentally undermined.

In this context, it should not be a surprise that providers closely scrutinise whether a PbR programme is worth bidding for and, if they bid, whether a much greater margin is required to offset risks. Scenario analysis, such as making the contract pay for itself even at very low volumes, will almost inevitably set a unit rate which would be higher than at 'normal' levels.

Yet unless government is prepared to contractually commit to volumes, providers may find themselves with no other acceptable choice.

To date, government willingness to guarantee volumes has been extremely limited, and a number of smaller programmes have been specifically designed to transfer the onus on to the provider. The risk of this approach is that commissioners limit the market of providers willing to take on contracts, and furthermore suffer a higher cost of delivery from those who are.

Using PbR at scale



External factors and unreliable volume projections will have unavoidable effects on the delivery of PbR contracts.

When used at scale, providers have to approach all PbR contracts with an appetite for risk – and price accordingly.

Concluding thoughts

Given that PbR necessarily reflects a political vision, it is likely to continue to attract controversy and debate. But it adds a unique dynamic to a contract – one that becomes more pronounced the greater the degree of risk transferred and the value of associated recompense. As PbR arrangements continue to mature, commissioners and providers will need to maintain a clear focus on whether the critical success factors are in place to make a mechanism a success. Based on experience of PbR to date, transferring outcome risk at scale requires commissioners to establish clearly defined and measurable outcomes, while making meaningful data available. For providers, an appetite for risk is essential.

Payment by Results is a complex and diverse topic. Deloitte has substantial experience of designing payment mechanisms for commissioners, of advising providers bidding PbR programmes, and of driving successful operational delivery in a PbR context.

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