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Form must follow function
Implementing new business models in UK public services

Contents

Acknowledgements

To support production of this report, Deloitte consulted senior figures across key government and private sector organisations, including:

Central departments

- Cabinet Office
- HM Treasury
- Department for Communities and Local Government
- Efficiency and Reform Group
- Mutuals Taskforce

Delivery departments

- Department for Work and Pensions
- Ministry of Defence
- Ministry of Justice
- Home Office

Service providers

- Business Services Association
- Serco PLC
- Interserve PLC
- Capita Group PLC
- G4S PLC

Local government, other

- Cambridgeshire County Council
- Hampshire County Council
- Leading public services reform academics
- Police and Crime Commissioners

These discussions together with research and our work on some of the UK's largest and most complex public sector programmes form the evidence base for this paper. Our thanks go to participating individuals and organisations.

Executive summary

Across the UK public sector, structural reforms are changing the provision of public services through a broader mix of public-private delivery models. Many of these models have their origins in the 1980s and 1990s and are already in use across government. What is new is the inclusion of mutuals and payment by results in the mix, and wider use of existing delivery models such as joint ventures and managed services that are now also seen as options for front-line service delivery. These changes are strongly influenced by a common challenge: there is very little money in government. New approaches must demonstrate they can deliver services for less.

The use of alternative delivery models may also depend on the existence of functioning markets and the willingness of service providers to enter them. In some cases, success will depend on provision of private capital and shareholder appetite for experimentation. For all delivery models, a key challenge is to introduce the right set of regulatory and competition economics that incentivises providers to innovate. Our research shows that, in flagship programmes across welfare and criminal justice, departments have come a long way in a short time to improve their understanding of provider behaviour. However, systemic weaknesses in government's commercial capability continue to act as a barrier to market development.

Our overarching conclusion is that to maintain the credibility of new delivery models and encourage their use, policymakers must embrace a mantra of 'what matters is what works'. Without evidence that models actually improve services or reduce costs, there is a danger that business requirements may be ignored in the rush to institute the model *du jour*. Failures from Railtrack to the UK Border Agency have shown that in public policy, form must follow function. Public bodies need to define what it is they want a new organisation to do and how it will drive performance and cost improvement.

Our other findings show that to 'industrialise' the process of mutualisation or leverage the potential of joint ventures for innovation and improvements in efficiency, a number of technical and cultural challenges must be confronted. We describe these as **five critical success factors**.

1. The business case is sacrosanct

Extended business case development, with supporting review cycles, are essential elements of successful change. The public sector has improved its ability to link policy design to implementation through professional development programmes and controls put in place by the Efficiency and Reform Group. But too often, a business case is developed to support a policy decision that has already been made. A case for organisational change should examine structures and finances, and ask tough questions around fundamental capability, skills and whether regulatory restrictions and conventions such as pay inflexibility undermine the case for change.

2. Focus on technical detail

A change of business model typically involves a number of technical issues such as capital financing arrangements, accounting systems, tax treatment, technology requirements, contingency planning, accommodation, asset valuations and transfer, management of liabilities and defining the procurement approach. These issues are often dismissed by senior policymakers as 'the plumbing'. In fact, taken together, they go a long way towards making the business case. Disentangling service delivery from government and introducing third parties into a supply chain is complex. Public bodies are likely to require extensive professional advice to stand up a new organisation. For businesses competing in delivery markets, credibility is vital, and it will flow from the soundness of an entity's technical arrangements.

3. Accelerate commercial credibility

Our research shows that, despite a succession of programmes across government and in local authorities to develop commercial capability, many providers still cite a lack of confidence in public sector procurement functions as a significant barrier to new ways of contracting. Points 1 and 2 above depend on underlying commercial capability to build effective businesses. But introducing new delivery models ups the ante. To move successfully from conventional procurement to alternatives such as payment by results or mutualisation, public bodies need a different mind-set.

To meet this challenge properly requires substantial investment to strengthen commercial capability, coordinated efforts to recast procurement and commercial functions as desirable careers with a clear route to the top, and an honest conversation about how pay restrictions constrain public bodies from appointing people with the highest-quality commercial skills.

4. Prioritise organisation design and development

Too often, organisations are created too quickly. For business models to work as intended, the structure of new entities must be properly designed, with suitable roles and responsibilities. Our research suggests that entities undertaking a rigorous organisational design process are better able to establish a structure for the new model to work well in practice. Commensurate work is also required on organisational *development* – picking the right behaviours, leadership, culture and capabilities – so individuals tasked with implementing new business models are able to deliver the target outcomes. Similarly, our evidence shows that at central policymaking level and for specific service delivery proposals, more work is needed to reconfigure organisations *within* government. The interface between parent departments and new businesses – their interdependencies, financial relationships and risk sharing – affects the success of the new business models. Our analysis indicates a need to improve the alignment between central finance and procurement functions and the wider corporate requirements of the new businesses. This could mean designing structures and capabilities from scratch rather than importing them from parent departments.

5. Reconfigure risk and relationships

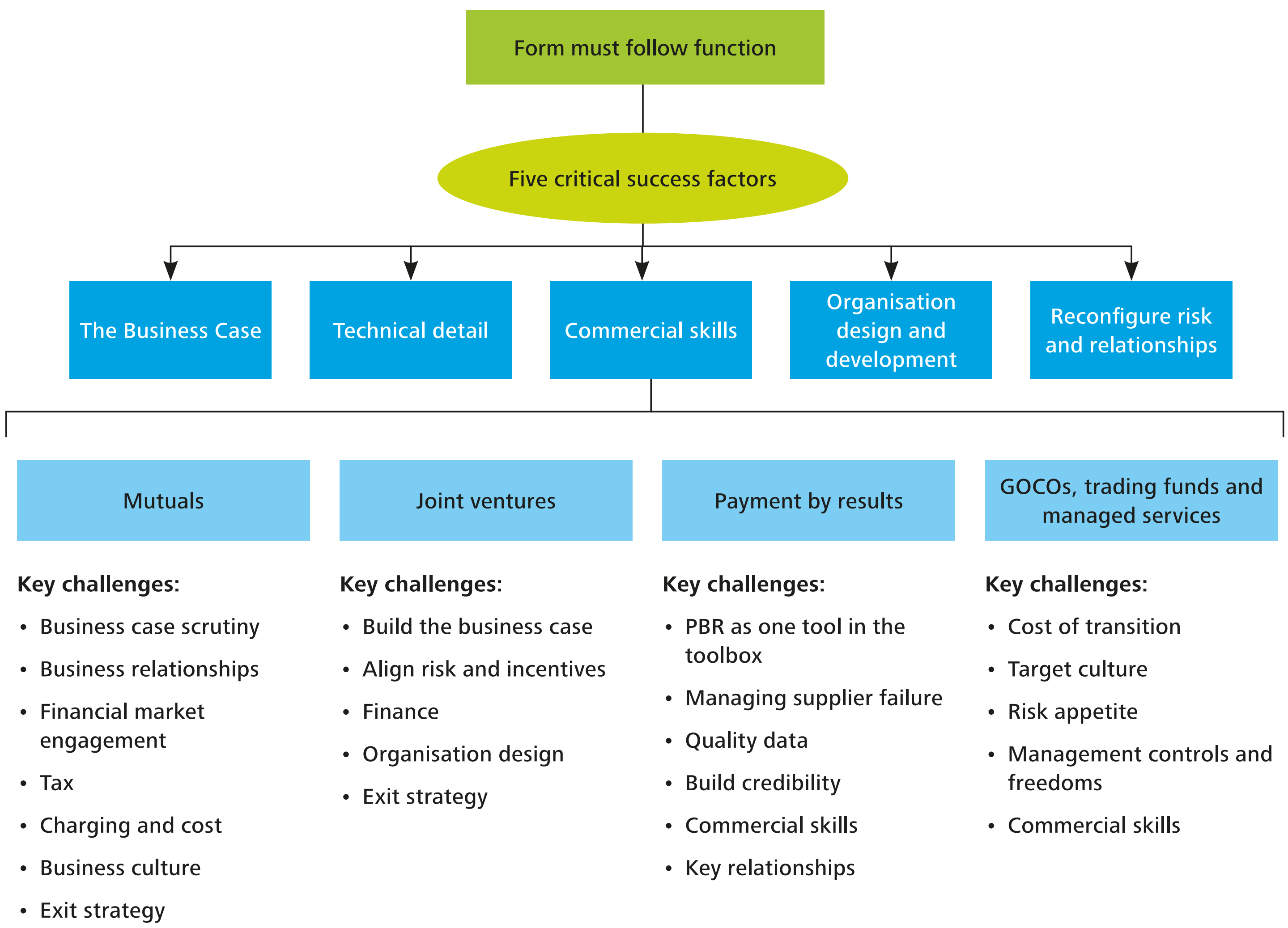
Differences in appetite for risk are often a key factor in selecting the right business model. Trading funds, which are an adjunct of government with little or no third party involvement and strong regulatory controls, typically involve minimal risk. Public sector mutuals, by contrast, have no record of service delivery at scale or successfully competing in open markets. In response, public bodies need to move away from a 'zero-tolerance' approach to risk that inhibits deal-making with service providers. They also need to be aware that some suppliers are nervous about participating in new markets when there is a lack of clarity about which models are likely to become permanent features across the UK public sector. Providers told us that they are more interested in deals where the onus is on them to take the risk of growing the business. But as business models increase in size, become part of a critical supply chain, or create new interdependencies with other public bodies, the risks and costs of failure grow.

So what?

Since 2010 solid work on policy and market development, and some tangible successes, have shown that new models can work in the UK public sector – up to a point. But to *transform* the delivery of public services in the way policymakers envisage, the use of new models has to be 'industrialised' right across a £700 billion portfolio of government activity. This can only be done as part of a long-term managed programme supported by policy interventions from above, cost improvement pressures from within and demand for service quality improvement from without.

Public bodies need to focus on the **five critical success factors** above. The analysis in this paper highlights the challenges for specific business models: mutualisation, joint ventures, payment by results, Government Owned-Contractor Operated (GOCO) models, trading funds and managed services. These challenges directly link into the critical success factors (see Figure 1 below).

Figure 1. Specific models and the five critical success factors



Source: Deloitte LLP, 2013

The challenges for each of these business models demonstrate the need to focus on fundamentals: a sound business case, technical excellence, commercial credibility, fit-for-purpose organisation design and a smarter attitude toward risk. Increasingly, government is no longer in the business of delivering public services directly. Instead, the priority is to build effective partners that can flourish in functioning markets. That requirement depends on investment in a totally separate set of commissioning and technical skills. Overwhelmingly, implementing new business models is about the right mindset. The rationale for new organisations should always be based on an objective assessment of what suits its purpose – *form must follow function*. To deviate from that logic could put vital public services at risk.

Local Government – Key Developments

Policy Drivers

Localism
Devolution of power to local level and opening markets to new providers is increasing as a result of the localism agenda. In local government, as elsewhere, this provides opportunities and challenges, allowing councils to take decisions that are appropriate to their specific contexts. However, localism also poses significant implementation challenges: see Deloitte's *A Little Local Difficulty: The Challenges of Making Localism Work*.

Fiscal austerity but increasing demand for services
Local authorities are currently in their third year of spending reductions. Over the period to 2016, local authorities must reduce overall spending by 30 per cent. At the same time, recession and demographic pressures are increasing demand for many services.

Opening up services to a wider range of providers
The combination of cuts and reforms is forcing councils to increase dialogue with a wider range of providers to explore ways of taking out back office costs without affecting front-line services, and to trial new models for service delivery, including new payment mechanisms.

Market Developments

Joint ventures
A rise in the number of public-private joint ventures reflects the tensions between cost-cutting and operational delivery. The joint venture model is used by councils for its flexibility. (JVs are not always constrained by public sector rules and regulations.)

Community budgets
Increasingly, community budgets are being used to pool (or align) funding from multiple public bodies, and restructure financial flows into a local area.

The rise of regional collaboration
Like other public bodies, councils are increasingly collaborating with each other to deliver back office systems and operational functions. Good and bad examples hide evidence suggesting regional collaboration, properly executed, can deliver significant cash savings.

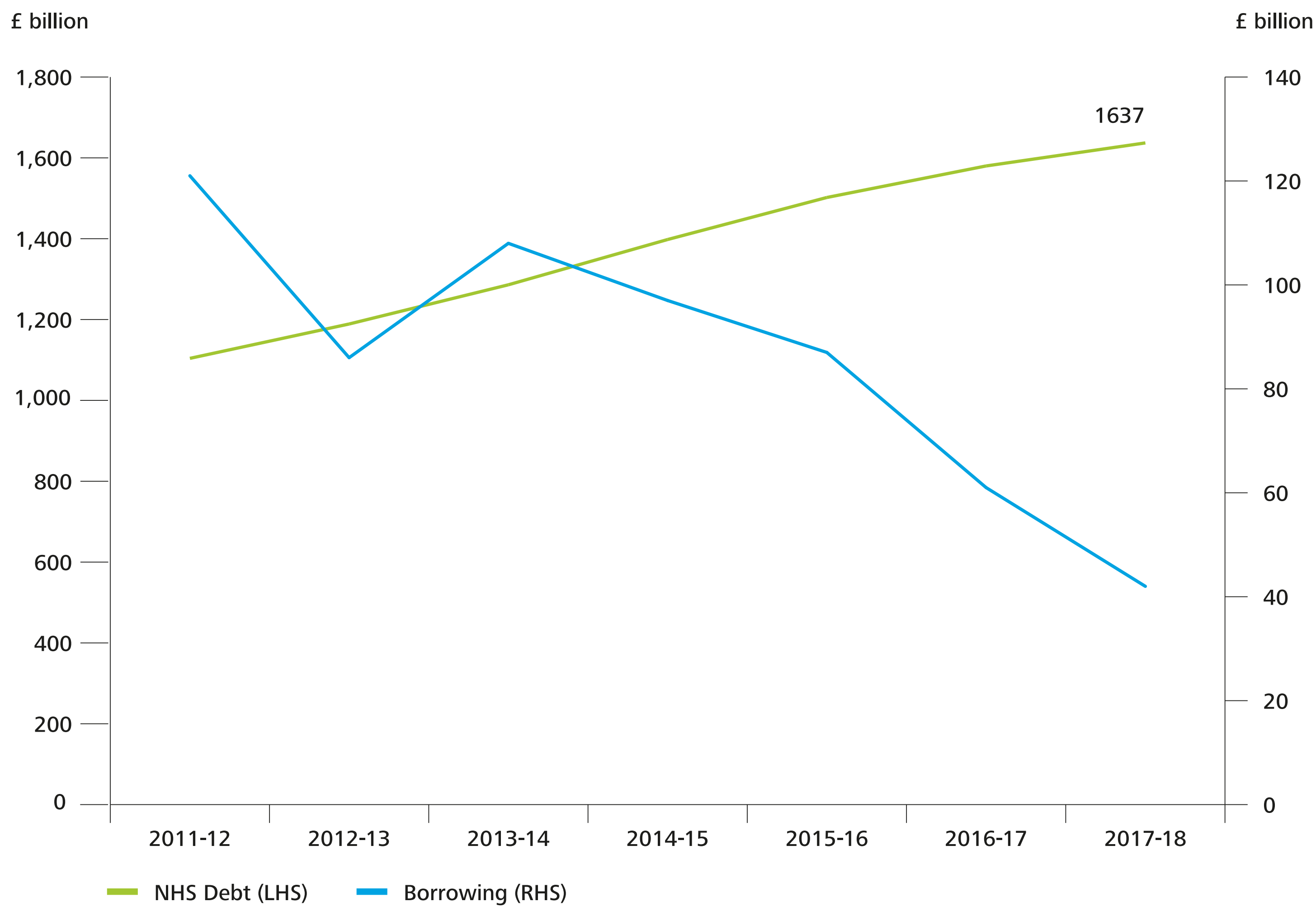
Balancing the books
In 2013, the NAO warned that 12 per cent of councils were at risk of being unable to balance their budgets, with 9 per cent reporting 'high financial stress'. Councils are already having to find greater savings than originally predicted due to higher-than-expected inflation and falling council tax receipts.

Context

The three years since the last election have seen accelerated change across UK public services, as cost and reform imperatives have begun to alter 'business as usual.' A variety of programmes are reconfiguring the way government is organised and managed. These programmes range across core public services such as education, health and welfare. They also involve new ways of working for service commissioners and providers as delivery partners.

In fact, the changes are an extension of a thirty year trend in marketization of public services. In the past, reforms were driven by structural interventions conceived at political level. While these values still define contemporary British politics, they have largely been overtaken by fiscal reality. The UK public sector faces austerity on an unprecedented scale. The cuts set out in the 2010 Spending Review were not so much a hiatus from real terms spending increases as the start of a drawn-out period of difficult choices. The effects of the 2008, 2010 and 2013 recessions disguise more fundamental problems in the public finances. Figure 2 shows the fiscal forecast in April 2013, predicting that the UK will carry a liability of around £1.6 trillion in net debt by 2017-18.[1] Debt interest alone will cost government around £1 billion per week next year, significantly more than MOD's annual budget.[2]

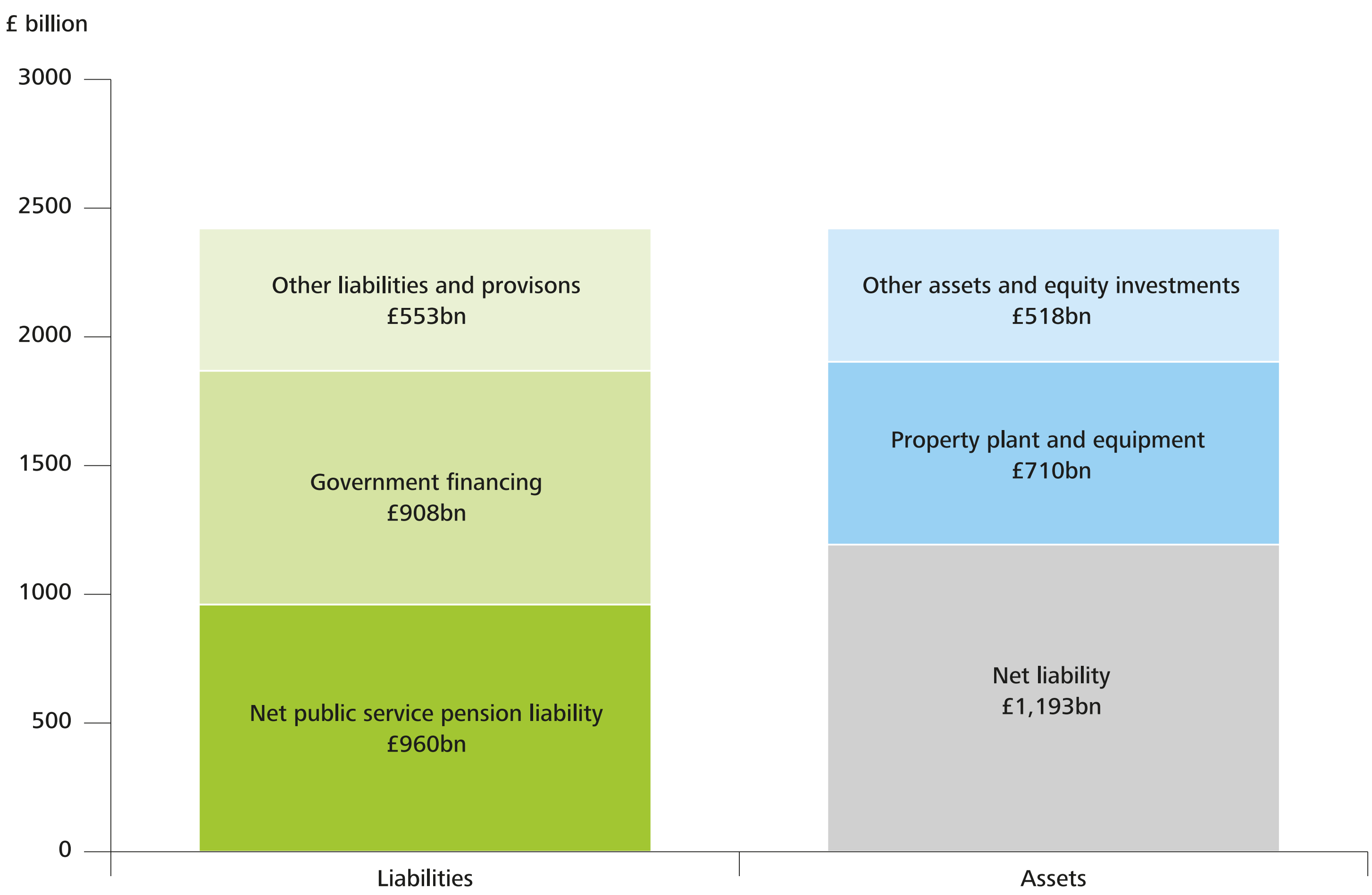
Figure 2. UK Public Sector Net Debt and the structural deficit to 2017-18



Source: Budget 2013, HM Treasury, 2013

This analysis has been well rehearsed since 2010. But less well understood is a further set of liabilities (Figure 3) that, combined with the impact of demographic change and the rising cost of treatment in healthcare, means that *austerity* as much as policy, is likely to drive change across public services in the coming years.

Figure 3. UK Government balance sheet 2010-11



Source: Whole of Government Accounts 2010-11, HM Treasury, 2012

For government, this means the focus on cheaper delivery is likely to intensify, not only across corporate functions and business processes, but also in front line services. Here, different models of ownership and contracting will form a patchwork of methods by which public bodies buy services. What form those new models will take, and what they require to function, is the focus of this paper.

For large providers that have grown their businesses around a paradigm of: 'build the model, run the model, scale the model', the new world of alternative delivery is forcing a rethink of market strategy. Despite their underlying entrepreneurialism and appetite for risk, our conversations suggest that providers are wary of new and untested ways of working with government – particularly given the risks of policy *volte face* and close Parliamentary scrutiny. Like public bodies, providers might also have to adjust their own risk models or working capital policy in response. Unlike public bodies, they must justify a go-to-market strategy to their shareholders.

This paper examines a series of new business models in use or under active discussion in government: mutualisation of public bodies, joint ventures, payment by results, GOCOs, trading funds and managed services. For each of these models we make a qualitative judgement, based on evidence, about their viability, relative maturity and progress towards wider implementation.

Ahead of this, we can identify some general trends that have a bearing on each model under review. In 2013:

- There is **broad political agreement** that in-house retention or traditional outsourcing may not be right for every public service. The previous administration reached a consensus of sorts with the provider market – underpinned by high levels of public spending. After an initial narrative that castigated large providers, the Coalition has acted to stimulate fresh conversations about doing business in a different way. This includes a series of policy changes that are breaking up public service monopolies: Clinical Commissioning Groups in health; Police and Crime Commissioners and probation and prison reform in criminal justice; opening up of supply in education; and the Localism Act in local government. A new locus of reform in the Efficiency and Reform Group in the Cabinet Office has created a central point for providers to engage with government at strategic level.

- An **ambition-capability** mismatch acts as a drag on new markets. Reform of public bureaucracies is a vital component of the efforts by Western countries to recast their economic models and meet the challenges of demographic change, technology and sustained low growth. Many of the proposed new business models are world-leading in terms of their scale and ambition (e.g. the *Work Programme*, and aggressive roll out of employee ownership models). Yet, typically for British policy-making, the problem is not a lack of good ideas, but varying ability to translate ideas into concrete service or cost improvements.

- Implementing new business models such as joint ventures or managed services is a complex task. It requires **judgments about target structures and likely behaviours**, together with a set of practical considerations such as the design of a new organisation, its governance structure, its financial arrangements including working capital availability, and management of its assets and liabilities. Concerns about whether public bodies have the capability to build these new organisations into sustainable businesses link to a wider challenge around commercial skills. Though not specifically relevant to the new business models, the Department for Transport's mismanagement of the West Coast Rail Franchise in August 2012 sent a message to service providers that central government still has problems with contracting effectively.

- A risk **appetite gap** between policy aims and contracting practices threatens to distort new ways of working. Many public bodies are still constrained by an underlying fear of 'getting fleeced' by providers. Their view of large-scale procurement is characterised by game theory rather than genuine partnership. This behaviour is partly influenced by accountability arrangements that have not been fully adapted to meet the new trends in public service delivery. Government holds ultimate responsibility for the safety and soundness of public service delivery, and many public bodies misapply this principle to eliminate risk, not manage it.

- Public bodies also need to consider possible **checks on innovation**. The use of innovative models typically involves new forms of relationship between commissioners and providers. But the evidence shows that contracting out works best in *established* well-functioning markets where there is provider experience in running new models profitably. Serious providers cannot simply switch between models as they emerge from the policy design process. Our research shows that it typically takes at least five years for third party providers to understand new models and respond positively to them.[3] In the outsourcing market, this means developing a handful of replicable models that can build credibility in key markets over time. Despite the loss of the UK's AAA credit rating, raising finance in the private sector is always likely to be more expensive than public borrowing.[4] So there may be instances where retention of in-house delivery is the most cost-effective option.

- Finally, modernisation of the **legal and regulatory environment** is vital to support roll-out of new business models. Countries such as Spain or Italy, that make extensive use of cooperatives, have specific legal frameworks, tax policies and capitalisation rules that underpin these markets. These frameworks provide financiers and intermediaries with the clarity they need to do business with new organisations. At present, the UK has a mix of different frameworks that can constrain reform. The Government is in the process of trying to simplify and update regulation to support new business models, including the introduction of new 'employee-owner' contracts that enable employees to exchange some of their UK employment rights for rights of ownership.[5]

The central theme running through our conversations is that the choice of which business model to use must be based on what a public body is trying to achieve – *form must follow function*. Beyond this and the other common factors above, feedback from our interviews suggests there is also a key question around measurement of success. The onus must be on commissioning bodies to explain how delivery of a service in a different way will lead to actual improvements.

This could be achieved by benchmarking corporate performance and service outcomes against national and international equivalents, and to compare overall cost and performance with in-house provision. The Government could think about formalising public sector productivity growth targets, where measurable, to build a clearer sense of what works and what doesn't from the range of business model options. Finally, it is an inescapable fact that labour costs typically account for around 70 per cent of department expenditure in the UK public sector. Commissioners should be clear that success with new business models is likely to translate into delivery with fewer people.

Policing Key Developments

Policy Drivers

Police and Crime Commissioners (PCCs)
The first wave of PCCs were elected in November 2012. Their role is to improve policing by holding police forces to account on behalf of communities. Budgetary power for the post has involved consolidation from a range of other local sources, including community safety funds. PCCs have also been given the power to commission services to address local crime prevention priorities. Several forces are consulting on proposals for a range of victim services. For more insight, see Deloitte's *Negotiating the Bill: the Introduction of Police and Crime Commissioners.*

Significant budget cuts
The 2010 Spending Review set out a 20 per cent reduction in police funding by 2014-15. This is having an impact on police numbers: by December 2012, 7,000 officer posts had been lost in England and Wales, with total cuts of 15,000 expected by 2015. Maintaining service levels in light of drastic headcount reductions is likely to generate new approaches to operational policing.

Implementation of Winsor Review
The majority of recommendations from the Winsor Review into police pay and conditions have already been implemented. Key themes were developing a stronger link between performance and reward, and changes to basic pay, severance and entry points into the profession.

Market Developments

Rise of inter-force collaboration
Police forces across the UK have produced tangible benefits from sharing back office services and some operational functions. In one example, Kent and Essex forces estimate that they have generated £6 million in savings after combining their IT directorates. The project is being scaled up to serve four counties, saving a further £3-4 million over four years.

PCCs have landed
In January 2013 PCCs in Bedfordshire, Cambridgeshire and Hertfordshire vetoed a planned outsourcing contract with G4S to provide IT and HR services. The police forces had planned to buy into an existing contract in Lincolnshire. Individual forces are currently considering whether to outsource some services separately. This intervention demonstrates how PCCs will change the commissioning and contracting landscape.

Centralised procurement
Centralised procurement through the National Police Procurement hub will be used to unlock economies of scale across commercial activities. The hub is a subscription service that provides access to electronic procurement management, and is projected to save up to £30 million.

Mutuals

As a flagship policy from the Government's *Open Public Services White Paper*, mutualisation of public services has been supported since 2010 through significant investment, political capital and central government machinery. Despite this, only one central government entity – My Civil Service Pension, created in April 2011 – has emerged from a pipeline of proposals. The agenda has been driven centrally by ministers who, having identified employee ownership as a means to drive innovation and efficiency, have asked Civil Servants to backfill the details of technical implementation. In practice, this 'technical detail' exposes a number of uncertainties that has led the Government to reposition mass-mutualisation of public services as a medium-term target.

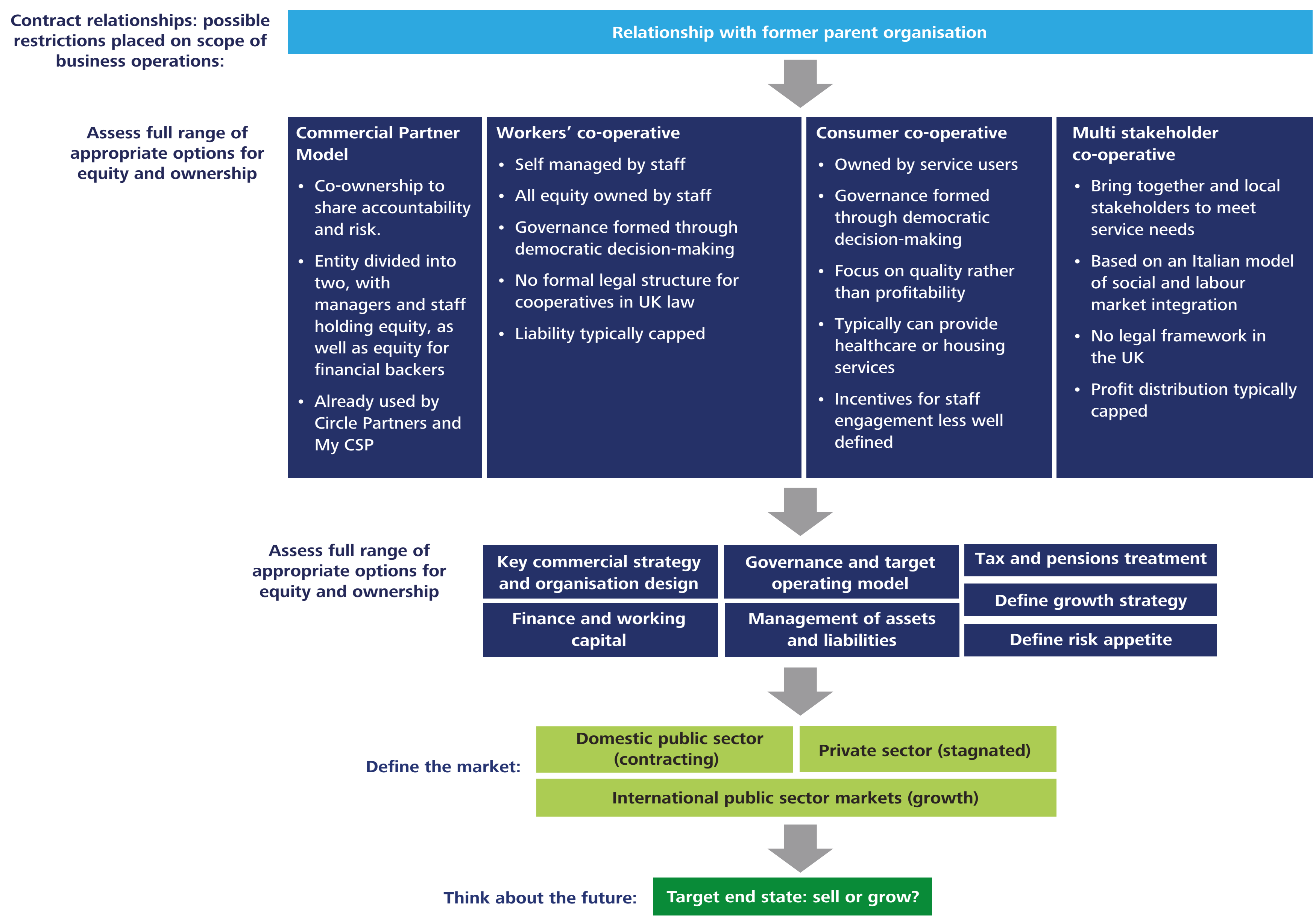
However, after a slow start there are now around 70 mutuals in the UK public sector, with the majority providing specialist health or community services. Mutualisation enjoys support in the social enterprise and voluntary sectors, and has clear political consensus. Interestingly, the majority of mutualisation projects have been driven by female leaders in public bodies. Enthusiasm amongst public sector workers is consistent with the Government's target to transfer one million public sector workers into mutuals, with almost one fifth (18.9 per cent) of respondents to the *Public Leaders Network survey* citing mutualisation as a viable option.[6] On the other hand, the 2012 Nuttall Review of Employee Ownership highlighted a chronic lack of awareness of the opportunities for mutualisation across the UK public sector.[7]

Progress so far has created a clear platform, if not critical mass, for exponential growth of mutualised public bodies. A key issue will be whether policymakers can raise the threshold of business complexity and risk above which mutualisation is not viable. At present, what works for relatively small or niche providers of specialist health and community services may be less viable in areas where, in practice, the most money is spent – high volume transactional businesses, such as those found in HM Revenue and Customs, the Department for Work and Pensions, or the Ministry of Defence. Mutuals currently in operation only account for about 0.14 per cent of total public spending.[8] To extend the model out from localised community businesses into highly-regulated national public services, our analysis shows there are **seven** technical and cultural challenges that policymakers need to address.

1. Greater scrutiny of the business case

Greater scale, interdependency with other public bodies and proximity to the core business of government bring increased risks. In response, proposals for mutualisation will require high-quality advice on revenue certainty, financial modelling and the requirement to hold specific capital assets. Mutualisation of a large department or agency might need several years of due diligence, market testing and a significant injection of new skills to turn it into a commercial operation (Figure 4). If policymakers begin on the basis that new mutuals should be capable of operating in competitive markets, and not as a single monopoly provider to government, then it will be vital for businesses to build up a track record of marketplace credentials, relevant skills and capacity for growth.

Figure 4. Key criteria to assess employee ownership options



Source: Deloitte LLP, 2013

Mutualisation: Some success…

SEQOL
SEQOL, established in 2011 by its commissioners NHS Swindon and Swindon Borough Council, provides health and social care services to residents of Swindon and surrounding areas. A Cabinet Office review highlighted an increase in patient visits of four per cent and efficiency savings of £3.9 million within the first year. SEQOL has also been successful in collaborating with other organisations, including the John Lewis Partnership and academic institutions such as the Universities of Gloucestershire, West of England, Stirling and Oxford Brookes. SEQOL's Chief Executive also acts as a 'Mutuals Ambassador' in the Cabinet Office scheme to promote knowledge-sharing between leading figures in current public service mutuals. This scheme could act as a catalyst for the successful performance of mutuals in other sectors, by transferring skills and experience across organisations.

Cleveland Fire Brigade
In 2012 Cleveland Fire Brigade became the first fire and rescue service to announce plans to mutualise. Driven by an £8.2m reduction in funding, Cleveland's decision was guided by its previous activity in the social enterprise sector, when the Brigade established a separate social enterprise wing to provide fire prevention services to customers in the local area. The mutualisation plans were backed by Cabinet Office with a £95,000 grant. Mutualisation will enable the Brigade to take control of management and operations, with potential benefits around efficiency and cost reduction. However the largest benefit will be the freedom to enter into commercial service contracts. The Brigade has already entered into a contract with a local industrial firm to provide round-the-clock emergency cover. Although this approach may create complexities around ensuring fair service provision, it has begun the process of commercialisation. Plans are in place to offer a similar level of service to other customers and to market Cleveland's capabilities to international customers.

Greenwich Leisure Ltd
Greenwich Leisure Ltd. (GLL) was created as a result of fiscal contraction in 1993. With funding reduced from the local authority, GLL became the first mutual providing leisure services in the UK. Twenty years later, GLL runs over 115 leisure facilities across London and elsewhere, with all profits re-invested in the enterprise. It has also diversified its portfolio by expanding into the provision of libraries and other education services, and built a wider mandate to promote healthy lifestyles. Amongst a wide range of awards and accreditations, GLL was the recipient of the 2011 Big Society Award and the first leisure organisation to be awarded Charter Mark (now Customer Service Excellence Scheme) in recognition of good customer service.

Circle Partnership
When Circle won a tendering process to run Hinchingbrooke Healthcare NHS Trust in 2011, it attracted attention as the first non-public provider of full NHS district general hospital services. Circle also operates a number of medical and treatment centres elsewhere in the country, including Reading and Nottingham. It is a private sector health care partnership that uses co-ownership to share accountability and risk. The organisation comprises the Circle Partnership, owned by its consultant partners, and Circle International whose equity is owned by institutional investors. Circle's business model centres on employee co-ownership, putting front-line clinicians at the heart of management. Since the takeover of Hinchingbrooke, a number of patient survey indicators suggest it has led to service improvement. Financial deficits have also been cut much faster than expected. 2013 saw Circle fend off competition to renew its five-year contract to provide services at its Nottingham NHS treatment centre.

2. Define the relationship with the legacy parent department

The most important relationship a new mutual will have is with its former parent organisation. Typically the initial order book will be dominated by business from the commissioning body. Contractual arrangements will need to be codified and take account of EU procurement and regulatory constraints. It will be critical to agree how and over what timeframe a mutual might expand its commercial activities to sell to other customers. To support these changes, new skills and structures may be needed in the commissioning body as well as in the new mutual, including commissioning and competition economics skills to help set up the mutual to succeed. A process for designing the organisation structures (including roles and responsibilities, governance structures and how 'interfaces' will work) for both the commissioning body and the new mutual is also needed.

3. Dependency on financial market understanding and engagement

Almost all mutuals will require working capital and investment capital, as well as access to financial products and debt markets. Some may take on liability for fixed costs and overheads previously carried by the parent organisation. But at present mutuals are generally regarded as an unknown entity by mainstream lenders. Policymakers need to engage the financial services industry, especially in debt financing, if employee-owners are reluctant to have their stake diluted through equity financing. Separately, new approaches must be found to overcome the fundamental problem of employees lacking funds to 'buy in' to a new mutual at start-up. The Nuttall Review advocated extended use of Trust models to finance employee ownership and provide a stable and long-term structure.[9]

4. Tax treatment

The Government Financial Reporting Manual sets out best practice in financial management for public bodies, including what is acceptable practice to minimise tax liabilities. This and other documents provide a clear framework for tax, as well as assets and liabilities more widely. In contrast mutuals have comparatively few sources of advice on tax. They may need to bring in specialist tax and financial planning advisers to value transferred assets or calculate tax liabilities. As much as Cabinet Office and other toolkits can support understanding of appropriate tax issues, actual tax treatments will vary between entities and the services they provide.

5. Understand charging and cost

A distinction frequently made between public bodies and commercial providers is that there is less understanding in the public sector about how to charge for services, including competitive and premium pricing and the use of loss-leaders to acquire market share. Public bodies also have a mixed record in understanding the true cost of providing services, including the cost of bidding for contracts and other overheads that may squeeze margins or drive up prices. This matters less for conventional public bodies, but for mutuals it is a vital set of skills that will be required to compete in open markets.

6. Business culture

Setting up a business involves personal risk and liability. To be successful, mutuals need to use employee-ownership to drive a customer-focused culture and better service outcomes. The market view is that these instincts are in short supply across public bodies, but our conversations showed this to be wide of the mark. There is significant appetite for taking on risk in small and niche public sector providers. Many of the mutuals now in operation have been taken forward by a handful of individuals who have 'sold' their idea to colleagues. Naturally as the scale of budgets and levels of risk increase, this risk appetite changes significantly across public bodies. Larger and more complex businesses may also face insurance liabilities and divergent employee views that make mutualisation more difficult. One possible solution could be wider use of joint venture mutuals, where a mutualised public body partners with an external provider on a shared equity basis. This approach could provide a solution to a credibility gap for mutuals, by introducing a track record of market credentials and tendering experience, as well as access to financing. MyCSP has been set up on this basis, in partnership with Equiniti Group and HM Government.[10]

…and some setbacks

The Audit Commission
Following the decision in 2010 to abolish the Audit Commission, ministers began a process to evaluate whether part of the Commission could be spun off into an employee-owned entity, to compete for local government and health audit contracts. Early analysis seemed promising, but in the end the business model was undermined in two ways. First, the way the tender for audit contracts was structured capped the amount of business available to a mutualised entity. In this case, tenders were divided into 10 regions and bundled up into four per region. But because contracts were capped at one per provider, the most the new entity could have won would have been 40 per cent of the work for which it previously had responsibility. Second, the new entity would have been at a fundamental disadvantage to its competitors, because even though it offered high levels of public sector audit capability, it could not show any track record of client work, nor satisfy the due diligence aspects of the tendering process. Further, it lacked its competitors' commercial skills and experience of bidding for work.

Central Surrey Health
Central Surrey Health provides therapeutic and community nursing services to patients in central Surrey. Created in 2006 as one of the first social enterprises to be spun out from the NHS, Central Surrey Health was lauded by ministers as an exemplar of a mutualised public body delivering better value and innovation to service users. In 2011 however, Central Surrey Health lost its first competitively-tendered contract to provide £500 million worth of community services in Surrey. Certain guarantees in the contract relating to balance sheet strength may have contributed to the decision to award the contract to Assure Medical, a private sector provider. Since then however CSH has successfully bid for a five-year £117 million community healthcare contract to continue delivering services in central Surrey.

Dingle Opportunities
Established in 1994, Dingle Opportunities is one of the longest-running examples of mutualisation in public sector service delivery. With a remit covering much of South Central Liverpool, it seeks to promote entrepreneurialism, self-employment and community action to regenerate local communities and reduce unemployment. But events in 2011 show how the continuity of service provision by a mutual can be at risk. Dingle Opportunities ran a number of centres ('JET centres') to provide assistance to unemployed residents in a particular area of Liverpool. The local authority ran similar centres elsewhere in the City through the 'Liverpool in Work' programme, and sought to close the duplicate JET centres. Disagreements arose over which organisation was liable for redundancy payments to the affected JET centre staff. The JET centres were eventually closed, and employment services are now provided through the 'Liverpool in Work' scheme.

7. Consider the endgame

Our research into mutuals reveals a need for commissioners and staff to consider endgame options. A number of interviewees thought that many mutuals would end their lives as private sector acquisitions. This might happen as a response to crisis, for example when a mutual fails in some way, or if employees decide to cash in their equity. If a heavily-capitalised outsourcer made a loss-leading bid for the business, government might have little influence over how staff responded. In another scenario, a mutual might not develop the capacity to govern itself effectively, which would result in a situation where the organisation stayed off the government's financial accounts but became a trading arm. In response to these risks, government may need to install adequate protections against QinetiQ-style sell-offs. This is an important concern, particularly if a large system-critical public body decides to mutualise.

Mutuals: key judgement

Their good work across specialist health and community services shows that mutuals are viable as business models in some areas of public service delivery. However most government spending and activity is not in these areas, but in large departments, agencies and core local authority services. Here, the benefits of the mutualisation model are less clear. The risks and challenges of implementation increase exponentially with size, and it may be harder to build appetite and consensus for mutualisation amongst employees in larger organisations. If the Government decides to expand mutualisation in these areas, it must take account of the seven challenges above – particularly the need to build a robust business case and define the relationship with legacy organisations.

Health Key Developments

Policy Drivers

Growing pressure on NHS Trusts

Real-term funding growth over four years runs at 0.1 per cent per year, but demand for services is rising at 2.6 per cent per year. The Nuffield Trust estimates that the combined effect of an ageing population, salary increases and higher drug prices could cost £34 billion more annually by 2020. According to best estimates, this increase can only be partially offset by successful execution of plans to increase productivity and efficiency in the long term.

Continued structural reform

The Coalition's vision for NHS services is founded on greater autonomy from government, more openness and increased patient choice. Following on from the Health and Social Care Act, in December 2012 the Department of Health published a detailed operating framework for service improvement, and local Clinical Commissioning Groups have taken on responsibility for local services.

GP commissioning

Clinical Commissioning Groups will set local priorities for service delivery in consultation with the community. They will be accountable to NHS England, the national commissioning body, and will be overseen locally by Health and Wellbeing Boards, which will be required to approve their plans. Local authorities will also contribute to a complex governance framework, but will retain the ability to challenge major service changes.

Market Developments

Quality, Innovation, Productivity and Prevention scheme (QIPP)

QIPP is a national strategy covering the whole NHS. It aims to improve the quality and delivery of NHS care while reducing costs and making £20 billion worth of efficiency savings by 2014-15. In December 2012, £5.8 billion of savings for 2011-12 were reported against a target of £5.9 billion; the National Audit Office validated £3.4 billion of this total.

Exploring alternative delivery models

Healthcare provision, in common with other areas, is increasingly exploring outcome-based payment models. Examples include prime contractor models and the 'any qualified provider' approach.

Greater private sector involvement

For-profit organisations are becoming more involved in core healthcare delivery. High profile examples include the takeover of Hinchingbrooke hospital by Circle, and the outsourcing of Suffolk's community healthcare services to Serco.

The return of private finance?

PFI deals have received negative press coverage as some NHS Trusts struggle with unsustainable debt payments, prompting the creation of a £1.5 billion support package for seven existing PFIs. In March 2013, the Government announced the first new PFI deal since 2010, after a two-year consultation failed to offer a radical alternative.

Joint ventures

In contrast to mutualisation, the joint venture (JV) model has a track record across public service markets. Public-private joint ventures that combine technical expertise of the public sector with commercial skills of the private sector are relatively common in central and local government – although a number of entities that are labelled 'joint ventures' are, in practice, straightforward outsourcing deals. This distinction between JVs and outsourcing is important. JVs typically align incentives through genuine collaboration and partnership. In comparison, outsourcing deals are still defined by a classic principal-agent relationship, where risk lies with the commissioning authority. JVs are different from outsourcing models, Government Owned-Contractor Operated entities (GOCOs) and trading funds, which all involve retained ownership by the public sector. JVs split ownership and create long-term partnerships, either to deliver a service or to commercialise assets through new routes to market.

Following the 2010 general election, the market for public sector outsourcing faced three years of low growth, as initial departmental responses to the 2010 Spending Review led to smaller and fewer contracts. A mixture of bad headlines, Parliamentary scrutiny and Cabinet Office interrogations further damaged relationships between the public sector and providers. In spite of this, and as an inevitable consequence of long-term budget cuts, the proportion of spending through outsourcing deals has grown significantly since 2008 – particularly in local government where the value of contracts has doubled, and in defence where it has trebled.[11]

Perhaps in response to this growing pipeline of conventional deals, appetite for new delivery models among large outsourcing firms is mixed. Plans for wider use of payment by results in service delivery have generated some interest among providers (see page 21). But most of them see opportunities for wider use of joint ventures, not only in traditional areas such as corporate and middle office functions, but also in delivery of front line services in areas such as health, criminal justice and policing.

Providers told us that they are particularly interested in JV deals where the onus is on them to take the risk of growing the business. They are also interested in opportunities where there is potential to access more than one market or group of customers through multiple delivery capabilities. On the government side, wider use of community budgeting that seeks to pool funding from multiple public bodies, and restructure financial flows into a local area, may create further opportunities for cross-sector deals. The introduction of specific structural changes such as Police and Crime Commissioners may also support area-based deal-making that attracts the private sector.

Joint ventures: Some successes.

Norse Group
Norse Group is wholly owned by Norfolk County Council; it specialises in delivering facilities and waste management, and property and care services in partnership with clients. Its strategically important long-term public sector clients include Suffolk County Council (in-house passenger services), Barnsley MBC (property), and Devon County Council (cleaning). Group revenue in the year to January 2012 was over £200 million, and since 2004 it has established a further 15 joint ventures with public bodies. Despite its public sector ownership, Norse controls its own pay and conditions, retains its profits and operates its own back-office systems. Its commercial independence has given it freedom to respond more quickly and decisively to changes in the market. It has also demonstrated an ability to absorb changes in staffing levels, for example those caused by the TUPE of staff from the public sector. Norse also has a strong forward order book, stemming from a series of large-scale, high-value contracts, which have given the organisation stability to build for the future.

Service Birmingham
Service Birmingham is a joint venture partnership between Capita and Birmingham City Council. The £474 million contract in 2006 was a ten-year deal to deliver ICT services and manage the council's revenue service and contact centre, as well as a number of other IT-enabled solutions. Despite changes to political leadership and reduced council budgets that might have derailed other joint ventures, Service Birmingham's success demonstrates how the JV model can work if contracting parties are prepared to be flexible. Service level improvements, cost savings and investment, and workforce capability building are testament to how Service Birmingham has delivered concrete improvements since the JV began. More recently, Staffordshire County Council's joint venture with Capita to provide educational support services is an interesting variation on how councils are collaborating to improve education services and attract additional investment to their local communities.

NHS Shared Business Services
NHS Shared Business Services (SBS) was set up in 2005 as a joint venture between the Department of Health and Steria. The organisation was created to target cash savings through significant economies of scale and is on track to deliver £224 million worth of savings to trusts over ten years. By July 2012, 45 per cent of all NHS trusts used the shared business centre, and the Department of Health has now struck a £15.8 million deal for all new clinical commissioning groups to use the service. As a commercial venture, NHS SBS has performed well up to March 2013, with revenue up to £62.4 million from £53.3 million in the previous 2011-12 financial year. Profits before tax and fees were up from £3 million to £4.6 million. This enabled the business to return £1.9 million to its client trusts in 2012.

GSTS Pathology
GSTS Pathology was formed in 2009 as a joint venture between Guy's and St Thomas' and Kings College NHS Foundation Trust and Serco PLC, to deliver pathology services. Set up as a limited liability partnership, GSTS currently carries out seven million tests a year for 1,000 customers. One of its partners, Kingspath (the pathology services arm of King's College Hospital NHS Foundation Trust), is home to one of the largest automated laboratories in Europe. The partnership plans to replicate its approach across the NHS. It already operates pathology services at Bedford Hospital, and in March 2013 it won a contract to operate pathology services on behalf of NHS Midlands and East Strategic Health Authority cluster.

To achieve growth in the use of JVs and other shared equity vehicles, our conversations with government and providers illuminate **five** challenges.

1. Building the business case

Once again, as with mutualisation, payment by results and managed services, form must follow function. Near-term cost reductions or a desire to move specific liabilities off balance sheet are not *prima facie* reasons for establishing a JV (although they can offer second order benefits). Rather, there must be a business case that demonstrates potential for long-term improvement in service delivery, or a better way to commercialise an asset. Our conversations with local authorities suggest that, at present, the use of JVs can be strongly influenced by the character of local politics and the differences between unitary and two tier local areas. Core elements for establishing a new JV entity will be business case development and an extended period of commercial due diligence. Key components of the process are set out in Figure 5.

Figure 5: Planning and implementing public service joint ventures

Initial planning	Options analysis	Business case and planning	Select partner(s)	Stand up and run
• Define business scope • Run benefit realisation work • Identify legal , accounting and regulatory issues • Run market analysis and testing • Install project governance arrangements	• Run initial due diligence on asset and IP – including valuations • Appraise project delivery options • Run legal, financing, accounting and tax reviews • Assess requirement for state aid, applicable competition rules etc • More market testing	• Develop detailed proposals for JV legal structure, asset transfers, and financing • Confirm procurement approach • Build organisation design, management and governance structures • Identify contingency, exit or termination strategies	• Define selection criteria • Pre-qualify bidders and enter dialogue phase • Stress test corporate objectives to ensure alignment • Review financing proposals • Agree initial business plan • Bidders undertake due diligence • Select partner	• Final business case approval • Set up corporate infrastructures • Finalise and implement business plan • Ongoing resourcing and management of the JV

Appraisal and value for money assessment →

Source: Joint Ventures Guidance, HM Treasury, 2010; Deloitte LLP, 2013

Proposals to create a JV typically require pre-deal scrutiny by the commissioning authority, including market and competitor analysis, appraisal of the long term sustainability of the business plan, the balance sheet strength of potential partners and sources of funding. Importantly, public bodies must assess whether the size of their equity holding justifies the value of assets that will be transferred into the JV. Planners also need to make provision for contingency funding. If public bodies are unwilling to set aside capital to meet unforeseen costs, they must accept dilution of their equity share if private sector partners are obliged to supply additional finance.

2. Risk and incentives alignment

It is essential for JV partners to have mutual understanding of each other's long term business objectives, and also areas of potential conflict. Many JVs supply services back to their parent department as part of their core business. In these cases, the use of subsidiary contracting may be important to protect intellectual property and assets, or enable secondments and service agreements. JV entities involve risk sharing, but they should not be used as a mechanism for transferring risk from the public sector through the creation of an arm's length relationship. Management of risk must also include a process for possible dispute resolution, especially in the case of future employee buy-outs that involve independent asset valuations or evaluation of remuneration policies.

3. Finance and accounting

JVs often use debt finance to fund start-up and working capital, and access to further debt financing through bond issues can support growth as the organisation matures. Debt financing of JVs may involve a mix of grant funding, loans from partners and third party debt. Our research shows that most failed public sector JVs run into problems because of financing rather than delivery performance. Accordingly, significant amounts of time and resource should be invested, and specialist advice should be obtained, to identify the right financing options for each new JV proposition. Similarly, the tax implications of a new JV can significantly affect the financial and business case. Tax issues commissioners should consider include VAT and stamp duty (particularly where the sale or lease of significant assets is involved), the tax impact of partner financing where the interest on debt financing may be tax deductible and asset transfers that may involve capital gains tax liabilities. For the accounting treatment, classification is also important as it determines the budgetary and financial control framework under which new entities operate, and has an impact on government's overall fiscal position.

4. Organisation design

The legal form of new JVs has a direct impact on its financing and ownership model. However, as with all organisations, the effectiveness of JV performance is strongly influenced by its governance, structures and capabilities. Developing the right organisation design is key. Employees with expert knowledge of the asset or the business may need to take on key roles in the new entity. In their preliminary work to stand up the JV, commissioners need to evaluate design options, including matters relating to accountability, legal status and management control. Planners have to achieve business continuity with a management team that may be drawn from two fundamentally different cultures. For larger JVs with diffuse business areas, clear accountability and 'line-of-sight' up to the board may be required. The JV may also need human resources policies and processes (including pay) that vary from parent bodies. As most public sector JVs involve staff transfers, commissioners may need to use incentives and controls to ensure that the right staff move across and are retained.

New entities may also require an iterative process of organisational *development* to build leadership capacity and develop behaviours and skills that enable the JV to perform at a level consistent with the business plan. Too often, new JVs do not give enough attention to organisational development and are subsequently obligated to make drastic changes. To avoid this, JV shareholders should establish a high-quality organisational development function (however it is configured – there are many options) with an organisational development strategy executed by experienced practitioners.

5. Exit strategy

A public body should not enter into a JV arrangement without a robust exit strategy. Most JVs have a fixed life span beyond which they are either wound up, sold or absorbed back into the public sector (usually in difficult circumstances). It is important that early discussions should focus on difficult issues such as disbursements of assets, equity and liabilities at sale or break-up. This requires independent valuation of assets and an assessment of the net present value of future earnings. Arrangements such as lock-in period for equity ownership, call options and pre-emption rights should be codified into the legal structure of the JV to mitigate unintended consequences at exit.

Joint ventures: key judgement

With some notable exceptions, a successful record of JVs in the public sector has demonstrated the value they can bring beyond conventional outsourcing, primarily through better alignment of incentives. Although JVs are complex arrangements, the benefits for the public sector in retaining control of service delivery or capitalising on the commercialisation of the asset can be compelling.

The introduction of general power of competence within the Localism Act 2011 may expand significantly the use of JVs in councils. Other key markets include health (such as Care UK's JV with Sussex Partnership NHS Foundation Trust to deliver mental healthcare and rehabilitation) and education (such as Capita's JV with Staffordshire County Council to provide education support services). Central government common functions such as property services may also become key markets for growth in the use of JVs.

Education Key Developments

Policy Drivers

Education reform
Education reform has been championed by the Secretary of State for Education around an underlying ambition to provide greater autonomy to schools. At all levels of education, from early years to higher stages, there has been a shift from a supply to demand-led provision.

Austerity
The Department for Education must cut administrative costs by 50 per cent by 2015-16. The 2010 Spending Review indicated funding reductions of 25 per cent and 40 per cent for further and higher education (excluding research) respectively. The cost burden of higher education has shifted towards service users directly as a result of the tuition fee increase.

The raising standards
The Government plans to increase standards in key education areas such as reading and maths, to improve the UK's ranking in international tables and to create a talent pool with the skills required to drive economic growth and global competitiveness.

Market Developments

Free Schools
Free Schools, based on continental models, can be established and run by independent groups supported by government funding. 79 Free Schools had opened in England by September 2012. At least a further 102 schools have been approved for opening in 2013. One form of free school, the University Technical College, aims to improve standards in technical skills education, specifically in science and engineering.

Academies
The *Academy Programme* established under previous administrations has expanded since 2010, further increasing the autonomy of schools. This policy has also seen the rise of large Academy chains. By April 2013, 2,886 academies were part of the education estate – up from 203 in 2010.

Administration
Many education support, administrative and other services have a record of private provision including catering, IT and interim/temporary teaching. As local authorities divest education services, this may increase further.

Higher Education
The Minister for Universities and Science plans to diversify the range of University providers, by increasing the number of private sector participants. BPP, which offers teaching across a range of professions such as law and accountancy, has recently become the first private organisation for over thirty years to be awarded University status.

Payment by results

Payment by results (PBR) is not a delivery model *per se,* but a method of performance contracting that involves payments to providers based on whether defined outcomes are achieved. Deloitte's *Hit the Ground Running* published in 2011 described a series of technical elements that commissioners need to grasp before using payment by results. Since that work, policymakers have had time to reflect on DWP's Work Programme and are developing several other schemes across criminal justice and local government. Recent comments by senior Cabinet Office and Treasury officials suggest enthusiasm for the model has waned slightly over this time.[12] Although well established, the *Payment by Results* programme in the NHS is actually payment for activity rather than results, and has been used principally as a mechanism to create greater competition between providers.

This distinction between payment for policy outcomes and business performance outputs is important. Payment for *outputs* is already widely used in the public and private sectors; for example, in many PFI and outsourcing contracts the provider agrees to a set of outputs such as reduced costs or interim service improvements that are verifiable through simple metrics such as call handling performances or error rate reduction in business processing – see Figure 6.

Figure 6: Outputs and outcomes

	Policy outcome PBR	Business performance PBR
Outcome	• Policy focus on 'social outcomes', e.g. employment, reoffending, troubled family resolution	• Focus on achieving 'business performance outcomes' e.g. cost reduction, improved timeliness, error rate reduction
Buyer requirement	• Credible business partner • Clear vision of how outcomes will be delivered • Demonstrable track record	
Provider requirement	• Clearly defined and measurable outcomes • Clarity on service level requirements • Simple and clear pricing structure	
Contracting vehicle	• Private sector providers • Joint ventures, alliances • Mutuals • Charity, voluntary sector	• Private sector provider – management / business partners • Joint ventures, alliances • Mutuals
Notable examples	• DWP – Work Programme • MoJ – Prisons Competition • Local Authorities – Problem Families	• MoD – Defence Business Services • DWP – IT transformation

Source: Deloitte LLP, 2013

In PBR, by contrast, payment is made on the basis of meeting policy outcomes that may be difficult to define and achieve, and does not necessarily involve system-wide savings. For example, if a reduction in reoffending is offset by an increase in the number of new offenders, no savings are achieved but the provider would have met its policy outcome targets.

The current market for PBR models in public services is limited to one or two high-profile programmes and a number of pilots and trials, primarily across local government. The outlook for PBR is broadly positive. A number of private sector firms we spoke to were in the process of configuring their engagement with departments and local authorities on the basis of a PBR model. However, public bodies, either through policy direction or for financial reasons, are actively seeking more sophisticated deal structures and more innovative procurement routes. They are also asking providers to develop hybrid delivery structures (such as partnerships, JVs, alliances and consortia) to deliver 'end-to-end' outcomes – that is, deals where one provider or a group of providers takes on the delivery for an entire service, including the underlying policy objective.

Insight from our discussions with providers shows that they expect PBR to be part of future public sector markets. But how each deal is structured will be vital to ensure the model functions sustainably. In almost all cases, some degree of market priming may be required, through investment in capacity building or improved competition economics frameworks. Providers told us that more work may be needed to change existing structures within PBR-sponsoring public bodies themselves. A good example is in the DWP where the Work Programme is effectively run as a 'bolt-on' to existing departmental structures.

PBR: plans in the pipeline

Troubled Families: Intra-public PBR
The Troubled Families Programme was set up in April 2012 to address the disproportionate cost of hard-to-reach families. 120,000 families cost government £9 billion a year, of which up to £8 billion is spent reacting to the consequences of social breakdown. In the new scheme local authorities are given up to £4,000 per family on a staged basis, receiving an initial 'attachment fee' followed by outcomes-based payments. From its inception, the programme showed some early signs of success. It identified 62,000 families to work with, helped more than 23,000 and made results-based payments for councils that intervened in 1,675 cases.

Drug and Alcohol recovery pilots
The Department of Health's *Drug and Alcohol Strategy* is aligned to wider government policy on local service delivery, setting out 'a shift in power to local areas'. Its pilot scheme involves working with eight local authorities to deliver PBR rehabilitation services. Interim views from the participating trusts have been largely positive, despite some significant implementation challenges. The trusts emphasise the culture shift required in some areas to deliver a payment by results agenda, which can only be achieved through effective communication internally to service users and externally to the wider public. Developing sustainable financial models is another important challenge. Participating trusts have undertaken reviews of the administrative functions that support the delivery of the models to ensure that they are fit for purpose and able to cope with an increasingly complex payments and tracking environment.

London Homelessness
In March 2012, the Department for Communities and Local Government and the Mayor of London announced an allocation of £5 million to help persistent rough sleepers into secure housing. The funding was made available through social impact bonds that aim to attract private/third sector investment to finance the start-up of projects, and pay-out occurs only if the project delivers agreed outcomes. The scheme is one of the first of its kind internationally. In December 2012 the Mayor announced an extension to the funding arrangements to a 'no second night out' pilot programme from the end of May 2013 to March 2015.

In 2011's *Hit the Ground Running* we identified five critical success factors to set up and run effective PBR contracts. These included a need to:

- Establish the contract fundamentals: outcomes must be clearly defined, measured, priced and understood by all parties.
- Manage unintended consequences: risk cannot be eliminated, but should be minimised.
- Examine overlaps in multiple programmes: where possible, commissioners should coordinate activities to realise efficiencies.
- Get clarity on the finance and accounting, including the full range of options to fund providers and how to account for the programme.
- Choose the right payment and performance models: payment structures must find the right balance between input, output and outcome payments and be flexible enough to reward varied outcomes appropriately.

Since then and through our discussions for this paper, we have identified a further six challenges that policymakers need to consider before they extend PBR across public services.

1. PBR is only one part of the jigsaw to create functioning markets

New performance-related contracting methods such as PBR are not necessarily enough in themselves to create effective markets and improvements in outcomes. An equally-important factor can be the shift in market share in response to performance. In the DWP's *Work Programme*, on-going competition is supported by the ability of providers to win work from each other across regional markets. PBR is the method by which providers are paid, but has no bearing on changes in market share. Policymakers might consider how to harness the appetite among providers for end-to-end service delivery through an outsourcing contract with some PBR elements.

2. PBR contracts need a process to manage supply-side failure

Given the experimental nature of PBR, public bodies need to 'design in' mechanisms to cope with provider failure or withdrawal. Markets function best when participants – even the largest – are allowed to exit without affecting service continuity. PBR contracts are designed to foster market efficiency through competition, but in practice market domination by a few key players creates moral hazard that might undermine the functioning of the markets. Individual PBR contracts are likely to require provisions for intervention in the event of failure, such as competitors taking over specific contracts. In the case of the *Work Programme*, the DWP only began contingency discussions with providers *after* problems surfaced with one provider.

3. Data drives high quality contracting

As *Hit the Ground Running* illustrated, all the variables within a PBR contract, including outcomes, have to be underpinned by high-quality data. For an intangible concept such as 'rehabilitation', risk transfer must be underpinned by clearly-defined, measurable outcomes and transparent performance data. This principle extends to market data and other external data with a bearing on outcomes. For example, providers are unlikely to have control over housing or access to healthcare although these have an impact on reoffending rates. Using data to demonstrate correlation between provider interventions and outcomes despite (or instead of) external factors will therefore be essential to maintain system credibility.

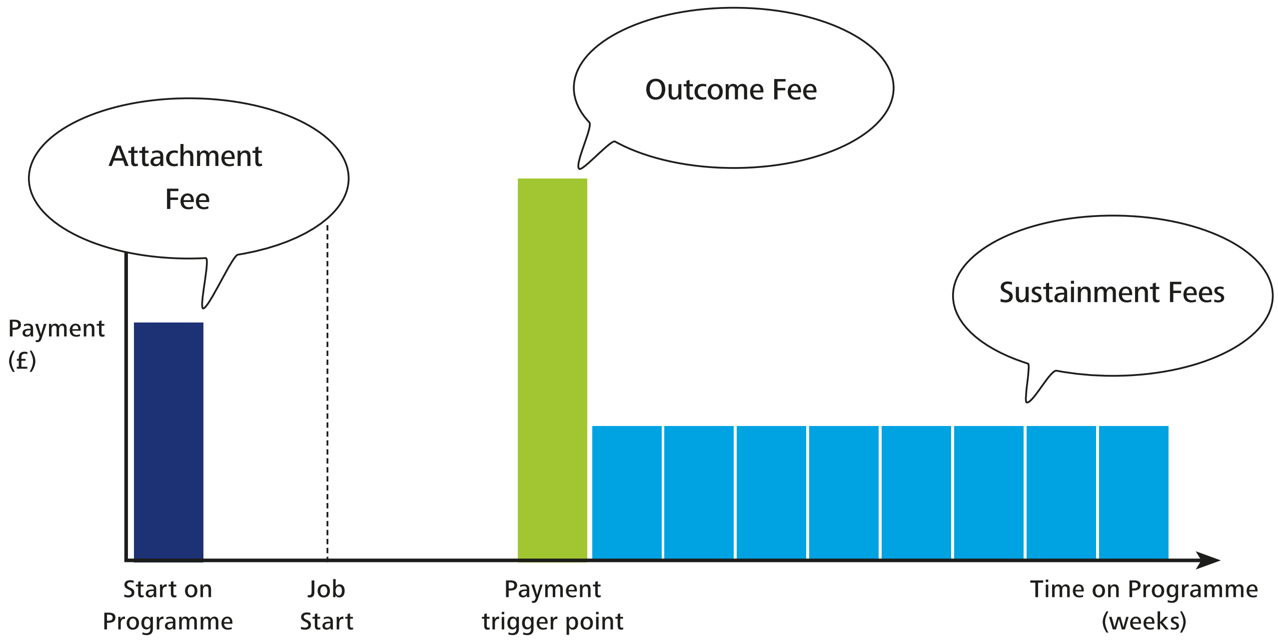
4. Build up credibility

Insight from our interviews shows significant provider uncertainty around PBR as a way to contract profitably with government. In response, it may be that large flagship programmes such as the *Work Programme* may be a less attractive proposition than smaller pilots involving limited liability and risk. Providers told us that they have little confidence that the new skills, behaviours and talent strategies required to run system-wide PBR contracts are in place across the public sector. Instead, public bodies could use PBR as a small 'sub-feature' of large outsourcing contracts. Rather than the 'big bang' of the *Work Programme*, public bodies could arrange contracts that include experimental elements of incremental PBR.

5. Contracting complexity demands high-quality commercial skills

As with other delivery models, PBR requires commercial capabilities and sophisticated competition economics that are not widely available in government. In the case of the *Work Programme*, it is too early to assess whether concerns that larger players are squeezing out smaller voluntary and social enterprise groups are justified. The same applies to fears about 'cream-skimming' or 'parking' of difficult individuals by service providers. Within the range of required commercial skills, designing the right pricing schedule is likely to be the most challenging for government. In the *Work Programme*, an input payment of about 20 per cent of the full contract is made to providers for taking on an individual who has been out of work for 12 months or more. The provider then works with the individual to find work, with payment increments typically fixed across a time frame of up to two years (Figure 7). This approach incentivises providers to support the overall policy objectives, which is to reduce UK benefits expenditure.

Figure 7: Simplified pricing model for the Work Programme



Source: Deloitte LLP, 2013

6. Ensure connections and relationships are properly embedded

As discussed above, some flagship PBR programmes have been 'bolted-on' to the main operating model of the parent department. Policymakers could consider instead how organisational structures, roles and responsibilities and incentive mechanisms could be embedded more effectively across participating organisations. During PBR implementation, an organisational review could be undertaken to identify how this might best be done in each case.

Payment by results: key judgement

Our conversations show significant but tentative market interest in PBR. It has the potential to attract new entrants, but working capital requirements and the credibility of the model amongst lenders act as barriers to supply side growth. Like other models, PBR requires genuine partnership to underpin contingency pricing. But it is not a silver bullet that guarantees innovation and efficiency. Any risks that providers cannot control are likely to attract a premium. There is also a fundamental tension between 'black box' commissioning and transparency over delivery. Public bodies need to become comfortable with the idea of minimal interference in provider methods, and several suppliers questioned whether in practice this is likely to happen.

Finally, a major risk with PBR is the development of provider monopolies and oligopolies. Although departments need strategies to enable consolidation as successful players absorb work previously carried out by weaker firms, they also need controls to ensure no further consolidation once a defined minimum number of suppliers is reached. In-house delivery of public services – effectively a monopoly – may be less efficient than a well-functioning market, but it is also more transparent and accountable than a model where providers are only answerable to shareholders. In building the case for PBR, the comparison to make is not between public and private provision, but between competitive market and monopoly. PBR is only useful if the former can be shown to work more effectively in specific social policy areas.

Defence Key Developments

Policy Drivers

Austerity
Since 2010, the MOD has taken forward significant spending cuts and implemented a series of strategic change initiatives. The MOD may need to find further reductions following the 2013 Spending Review.

Operational re-structure
The 2010 Strategic Defence and Security Review, alongside Future Force 2020, outlined significant changes to operational structure within the armed forces. Partly a result of austerity and a reduction in combat operations, this structural change aims to adapt the UK's military structure to become more efficient, lean and versatile.

Defence reform
Lord Levene's *Defence Reform* made 53 recommendations aimed at creating an agile military through a 'more professional MOD'. Recommendations include management changes to strengthen decision making and create a "single, coherent Defence Infrastructure and Defence Business Services".

Market Developments

Support services
Established in 2011, *Defence Business Services* provides corporate services to the MOD across functions such as HR and Finance. In 2012, it was contracted out and is an example of the scope for private sector involvement in easing austerity pressures and the consolidation outlined by *Defence Reform*.

New GOCOs
Plans are in development to establish a GOCO with a third party contractor to manage *Defence Equipment and Support*, an MOD procurement function. Ministers believe a properly-configured organisation will lead to overall budget savings from a "robust and focused delivery of equipment and support".

Frontline services
Involvement of third party providers is not limited to support services. Recent developments have seen contracting out of UK Search and Rescue Helicopter provision to Bristow. The private sector is moving into services not ordinarily covered by sovereign forces, such as private shipping protection, soon to be offered by Typhon.

DIO
In keeping with trends towards the consolidation of different MOD functions, the *Defence Infrastructure Organisation* was established in 2011 to manage MOD's estates. Invitations to tender were submitted to private construction firms in early 2013 for numerous capital projects across the estate – further evidence of the MOD's willingness to engage with third party providers to achieve objectives.

GOCOs, trading funds and managed services

This final group of models has been used widely to deliver functional aspects of public services at arm's length, such as scientific or research capabilities, business technology and management of intellectual property. However, with the general trend towards outsourcing middle and front-line aspects of services, some public bodies are evaluating whether these approaches should be applied to a broader range of functions and businesses.

Government-Owned Contractor-Operated bodies (GOCOs)

A government owner-contractor operated body (GOCO) is a whole-agency outsourcing arrangement, such as the Atomic Weapons Establishment or the National Nuclear Laboratory, where specialised functions operate under contract. Government retains ownership of the assets, but employees are contractors. (In contrast, 'GOGOs' are owned and operated by the public sector at arm's length from government, and employees are typically civil servants.) For both GOCOs and GOGOs, funding comes from various public sources and commercial markets.

As well as reducing cost, GOCOs can offer improved governance and transparency. They also allow public bodies to retain a high degree of control over the business where potential liabilities are too high for contractors to take on. Some areas currently under active consideration for creating GOCOs are procurement functions for high capital spending departments, scientific and technical services that support the police or military, professional development capabilities including colleges and training establishments and organisations for the management of transport schemes such as road pricing. However, as the pipeline for possible GOCOs lengthens, public bodies might consider the following key issues that came out of our conversations.

- **Transition can be expensive.** Business planners need to demonstrate that a new entity will provide functions or services of strategic importance to the commissioning body more effectively over a sustained period, but also that the cost of change is not prohibitive. Managing the transition is complex and invariably involves large-scale changes in human resources. Public bodies may need to appoint a strategic partner to help them manage the process.

- It is vital to institute a **clear business relationship** between the new business and the parent department. For example, the Atomic Weapons Establishment operates on the basis of total access to all records and processes for the client, in this case the MOD. The rules also allow the MOD to suspend the contract and take over operations in an emergency or replace contractors without disrupting operations.

- From the outset, the strategy for a new GOCO should include a plan to maintain the ability of the authority to **retender the provider contract in the future**. In some existing GOCOs, competition is possible but made more difficult, because the arrangement may not be transparent or separate enough to facilitate competition, or because the involvement of key incumbent staff in the retendering process risks significant disruption to service.

- The culture of a GOCO is likely to be **significantly different from its parent organisation.** Even if a new entity begins its life supporting a single customer, it should be configured to compete in markets that may be mature or international, or that have high barriers to entry. GOCOs therefore need a culture that prioritises commercial skills, capabilities and experience all the way up to board level. They may also require mature operational practices and efficient business processes to help them 'hit the ground running'. These capabilities must be designed-in from inception, and may require management capabilities brought in from outside or temporary external support. Finally, from the outset, a change management process should be designed and implemented that promotes the target business culture.

GOCOs: change and continuity

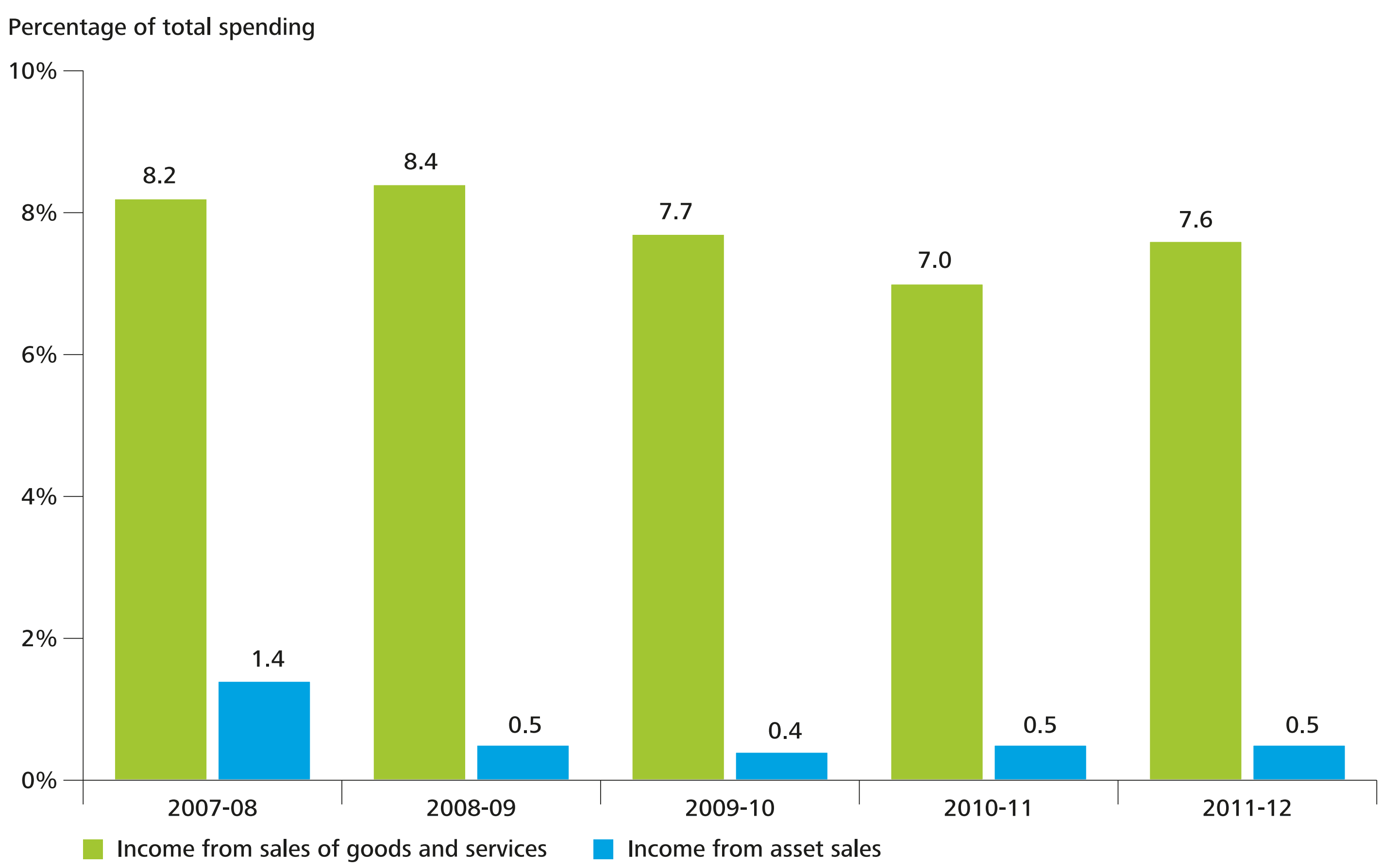
Defence Equipment and Support
MOD is home to some of the largest GOCOs in government, in part because of the significant risk and costs associated with provision of military capability and necessary long-term relationships with private contractors. MOD's procurement arm, Defence Equipment and Support, has recently launched a competition to test whether the business case exists to award a GOCO contract to a private sector provider. With a budget of £14 billion, DE&S would be one of the largest GOCOs in the UK public sector. It is expected that the costs of properly rewarding and incentivising the GOCO will be exceeded by the overall savings to the defence budget from robust and focused delivery of equipment and support.

The National Physical Laboratory (NPL)
The National Physical Laboratory (NPL) is responsible for defining and maintaining scientific measurement standards in the UK – from the valuation of atomic time through to measurement of biomolecules – and conducts a wide range of high calibre research for the science and commercial sectors. From 1995 the NPL has been managed by a subsidiary of Serco through a GOCO relationship with the government. In December 2012 the Government announced plans to change the current operational model when the contract with Serco comes to an end in 2014. The NPL will move away from the current GOCO model towards a possible joint venture between the Department for Business, Innovation and Skills and "one or more national/international academic partners or applied science organisations." This academic institution would have a "long term stake in the ownership and operation of the NPL which would not be possible under current arrangements." Whilst not necessarily a reflection of the performance of the GOCO model, the proposed change highlights the limitations for the government in changing operational and strategic focus when tied into a contractual relationship.

Trading funds

A trading fund is a statutory body created in consultation with the Treasury, usually as a vehicle for a revenue-generating business. As the relative share of income from chargeable services across the public sector has declined in recent years (Figure 8), there may be significant opportunity for public bodies to boost income through an extension of commercial activities. The public sector overall holds assets worth over £300 billion, the majority held in local government. It does not follow that trading funds may become more widely utilised; however it does mean that public bodies will become more active in seeking to 'sweat' assets harder, and generate more income through fees, charges or sales.

Figure 8: Government income from chargeable services and asset sales



Source: Public Expenditure Statistical Analyses 2012, Deloitte LLP, 2013

Trading funds trade directly with the market and cover their expenditures from their own revenue. They are not suitable when there is only limited market interest in the services provided. However they are viable as a low-risk model when there is a requirement to maintain significant government control (in contrast with a JV model). Prominent central government trading funds include: HM Land Registry, that commercialises the intellectual property it holds on land and property data; FCO Services, that provides internal computing, logistics and vetting services to government departments; and Ordnance Survey, that monetises its assets by selling maps and location-based data to the public and private sectors. Key factors to consider in setting up a trading fund include:

- **Financing.** Trading funds can borrow from government and invest cash surpluses. They are normally established with a mix of loan capital and public funds provided by sponsor departments. However the business plan must show clearly that the trading fund can generate a rate of return that matches its cost of capital, since trading funds are legally required to break even. It may be sensible to test whether the business can meet this requirement, by having a trial period of operation as a 'shadow' fund within the security of the parent department.

- **Skills restrictions.** Because of the strong dependency on their parent, trading funds may have more limited access to specialist skills than GOCOs and JVs. In response, public bodies may need to bring in temporary support to build commercial operations, and use targeted training packages to strengthen in-house capability. Unlike other models, core operations cannot be undertaken in partnership with the private sector. Pay and conditions are also in line with mainstream public bodies. Trading funds therefore remain adjuncts of government, and must find other ways to innovate and leverage their assets to maximise commercial potential.

- **Risk.** Any shortfall in revenue for a trading fund must normally be topped up by the parent department. The department, in partnership with the Treasury, must also be satisfied that the trading fund will be capable of delivery from day one, and demonstrate continuous service improvement. Separately, public bodies may consider whether improvements to management accounting and technology systems are needed ahead of launch.

Trading funds: long term players run their course

Defence Aviation Repair Agency
Established in 1999, the Defence Aviation Repair Agency (DARA) was responsible for the repair and maintenance of all aircraft within the UK's armed forces. ABRO (Army Base Repair Organisation) was established some years before to provide maintenance services to military equipment. Both were operating as trading funds in 2007 when a change in MOD strategy saw them merged to form the Defence Support Group (DSG). The new organisation operates as a trading fund owned by the MOD, with a central mission to provide cost-effective and timely overhaul, repair and maintenance services to the armed forces. However, continuing fiscal pressure led to an announcement that DSG would be sold by 2014-15 as part of the Strategic Defence and Security Review. The government hopes to raise £500 million from the sale of DSG and other corporate assets (and DSG revenues of £200 million per year).

Driver and Vehicle Licensing Agency (DVLA)
In April 2011 the DVLA lost its seven-year-old trading fund status, when it returned to its former status as an Executive Agency. Its trading fund status had allowed the DVLA to retain income to meet its expenditure needs. The DVLA was never fully established as a corporate body, which is unusual for trading funds. As a result HM Treasury deemed the agency's trading fund status to be inconsistent with its 'clear line of sight' accounting policy, aimed at aligning departmental budgets to ensure consistency. However in comments made to the Transport Select Committee in November 2011, the DVLA Chief Executive stated there was "no change whatsoever" to the DVLA's operational structure following the decision to become an Executive Agency.

- **Planning.** Once statutory, financial and administrative tests have been passed, managers need to establish detailed plans and a customer-supplier agreement. These might include billing arrangements, financial forecasts, the proposed structure of the opening balance sheet (including valuation and reassignment of specific assets and liabilities) and design of the organisation. During the initial stage, it may also be appropriate to consider whether functions previously provided by the parent department can be removed from the trading fund's mandate – in effect using the transition as a mechanism to stop providing unnecessary or expensive services.

- **Independent assurance.** As with other delivery models, the case for a trading fund should be independently reviewed, both from a legal and operational efficiency standpoint, and there should also be a more fundamental assessment of whether it will actually lead to service improvements or reduced costs.

Managed services

Managed services involve the end-to-end transfer of a corporate function – often technology services – to a provider. As a model it differs from mainstream outsourcing, which normally involves the transfer of staff via the TUPE process. Under a managed services agreement, a single supplier can act as a one-stop shop to provide a range of services and functions to the client. Many managed service providers supplying technology services to a public body provide similar services to other organisations. This makes possible cross-fertilisation of innovations and reduced costs through economies of scale.

Managed services: successes and failures

LGSS Northamptonshire
Cambridgeshire and Northamptonshire councils launched a shared services centre in 2010 to provide back office, professional and front-line services, including ICT, finance and HR. The combined investment of £3.3 million to set up the centre has yielded tangible savings, including £1.78 million from re-procuring IT systems. The service is forecast to save £9.4 million in annual costs in 2012-13, growing to over £18 million by the end of 2015-16. Significantly, an assessment was made that it would be commercially viable to bring payroll services back in house from an outsourced provider. LGSS now provides business support for a wide range of public bodies, including district and borough councils, schools and academies, health and emergency services, and pension funds.

2e2 wind up
Until 2013, 2e2 provided outsourced managed services to NHS trusts and other public sector clients. Two of its key clients were NHS North Central London cluster and the Sussex Partnership trust, which signed a contract in 2012 worth a total of £36.8 million over seven years. In January 2013 however, 2e2 was forced to place many of its companies into administration, following a period of rapid growth through a series of debt-financed acquisitions such as Compel (2007) for £53 million and Morse Group (2010) for £70m. This last acquisition was of a comparable size to 2e2 at the time. An inability to realise synergies from the acquisitions strategy, coupled with debt that became too expensive to service, resulted in a decision to put the company into administration. Plans are currently under way to maintain 2e2 data centre services in the short term and manage a transition to an alternative provider.

The market for public sector managed services has consisted mainly of technology deals, but reforms and austerity are starting to widen the category and scale of managed services agreements. One of the largest arrangements, Defence Business Services in the MOD, provides functional services such as vetting, finance and human resources. Our conversations for this paper show that providers are beginning to extend the scope of their managed service proposals into records management, facilities management, customer contact centres and business process outsourcing. Capita's acquisition of Northgate Managed Services for £65 million in March 2013 illustrates a market appetite for managed services in the education and regional public sectors.[13] More ambitious is the prospect of end-to-end service agreements for front-line service delivery. It is not yet clear what form the £400 million contracting out of probation services will take, or whether some 'externalisation' activity in the NHS will fit the definition of managed services. Clearly however there is potential for significant growth of this delivery model across mass-market elements of public services.

GOCOs, trading funds and managed services: key judgement

Our conversations with providers show that the appetite for GOCOs and managed services is strong. At present however, policymakers have prioritised the development of mutualisation and payment by results contracts as models for front-line public service delivery. GOCOs and managed services each have broadly successful track records in government, and although they may not be appropriate for all functional areas, we are aware of active discussions underway to extend their use into front-line public service delivery.

For GOCOs, managed services and trading funds, the key to success lies in the execution. Building a watertight business case that stands up to rigorous market testing will be a vital part of the process. As ever, defining the form based on a dispassionate assessment of function, and then standing up the organisation on the back of sound organisation design, will be important. An area where these delivery models align with the Government's narrative is the better use of assets and intellectual property. GOCOs and trading funds in particular can offer a viable alternative for limiting the risk in this process and running the operation in a sustainable way. But to do this, public bodies need to evaluate what is required in terms of control, risk, culture and management freedom to innovate before choosing the right model for the arrangement.

Welfare Key Developments

Policy Drivers

Austerity
Spending on social protection is estimated to reach £220 billion in 2013-14 – over 30 per cent of overall public expenditure. Political pressure to reduce the welfare bill from other departments is increasing, as further reductions loom in June 2013.

Overall unemployment
As part of austerity measures, public sector employment will fall by around one million jobs over the Spending Review period, with varying regional impact. The challenge is to boost private sector employment to offset these redundancies and to ensure that regional imbalances are mitigated.

Welfare dependency
The Government has sought to address long-term welfare dependency by reforming the benefits system. However, the number of individuals unemployed for longer than 24 months increased by 11.4 per cent between November 2012 and January 2013 compared with in the same period 12 months previously.

Market Developments

Universal Credit
The DWP is consolidating existing benefits into a single payment, *Universal Credit*. Five external agencies will deliver the programme, from development of system infrastructure to supporting business applications.

Work Choice
Launched in 2010, the *Work Choice* initiative utilises private sector providers to help disabled people make the transition to work. A 2013 report by the DWP suggests eight providers have brought 44,550 disabled people on to the programme.

The Work Programme
A flagship DWP policy, the *Work Programme* assists unemployed people to find work, with employment services provided by external agencies. This is based on a *Payment by Results model.*

Customer service
To drive value for money, the DWP has utilised third party suppliers to provide support services. For example an increase in use of needs assessments for disability benefit recipients is currently provided by *Atos* and *Capita*.

Youth Contract
Primarily aimed at unemployed 18-24 year olds, the *Youth Contract* engages private and voluntary organisations to provide work opportunities. It plans to support 500,000 young people over three years.

Notes

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