Local payment by results

Briefing: Payment by results for local services

April 2012

audit commission

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Summary

This briefing considers the issues arising from using Payment by Results (PbR) locally. Its purpose is to help those involved in commissioning and improving local services to understand what PbR entails; whether it is right for their circumstances; whether it is likely to deliver what they want; and how to avoid pitfalls. Our review of UK and international research evidence found few rigorous evaluations of PbR and no complete, systematic analysis of its effectiveness. The briefing does not therefore make a recommendation for or against PbR, but instead sets out the issues that commissioners should consider if they are to use it successfully.

PbR is a new approach to commissioning and paying for services.

- Commissioners pay service providers according to how well they achieve specified outcomes, rather than outputs or volumes of service.
- These outcomes may be social, economic, financial, or a combination of all three.
- PbR is not the only contract type that rewards good performance, and commissioners should always consider other options alongside PbR to choose the most suitable approach.
- What sets PbR apart from other contract types is that a significant amount of payment is withheld until the results are delivered. The payment is directly related to the level of success.

It is a key element of the government's policy for achieving 'better for less' from public services.

- National schemes to extend PbR's use are developing quickly. Some early schemes include reducing reoffending; diverting young offenders from custodial sentences; helping the unemployed to find work; preventing children from being taken into care; keeping frail older people in their own homes; and improving the management of chronic health conditions.
- The government's Open Public Services White Paper (Ref.1) states that PbR will 'provide a constant and tough financial incentive for providers to deliver good services throughout the term of the contract'.
- The White Paper also recognises that PbR brings new challenges and risks for commissioners, including accurately setting and carefully specifying outcomes, as well as getting the balance right between incentives for providers and the public interest.

For those who decide to use PbR locally, and do so effectively, there are significant benefits.

- At its best, PbR can deliver savings and bring in new resources at a time when budgets are under great pressure. It also defers costs to commissioners to allow time to realise the benefits of change and preventative work.
- PbR can provide sustained incentives for providers to improve outcomes, and to find new ways of doing so. It can encourage new ideas, new forms of service delivery and new entrants to service provision.
- Unlike other forms of contract, PbR aims to transfer financial and operational risks away from the commissioner, often onto the provider, or funding bodies. It can also provide clearer accountability for outcomes.

However, PbR carries extra risks to securing value for money and requires higher level commissioning skills than more traditional approaches.

- Schemes that make a large part of the payment dependent on performance are, for the most part, untested and their overall effectiveness is not yet proven.
- PbR could increase costs for commissioners and others. The provider may be too well rewarded if the performance bar is set too low. Other organisations that are not part of the PbR contract may incur costs because of its impact. Schemes may fail, leaving commissioners to fund continued service provision.
- Attribution issues and timescales to deliver mean the organisation that pays is not always the one that benefits.
- Designing and implementing PbR schemes needs extra care and attention to manage the risks and deliver the benefits.

Structure of the briefing

We have identified five principles that are necessary for any successful PbR scheme, but nevertheless do not guarantee success. This briefing is structured around these principles. They are closely connected and all are important. Each needs careful consideration before starting a PbR scheme.

1. A clear purpose. Commissioners should consider whether PbR is the right approach and clearly define its purpose. For example, is the purpose to improve outcomes, reduce costs, bring about innovation, or is it a combination of any or all of these?
2. A full understanding of the risks. Commissioners should understand and manage market and commissioning risks. PbR schemes should have clear contractual arrangements that set out financial and practical responsibilities, payment details and progress monitoring, and explain which organisation carries which risks.

3. A well-designed payment and reward structure. Incentives need to be right for providers to bid competitively and perform well during the contract, with an appropriate mix of core payments and reward payments. Payment schemes should avoid perverse incentives and support the scheme's outcome objectives, as well as balancing risk, reward and payment timing.
4. Sound financing for the whole scheme. Financial planning needs to look at the whole life cost. This should allow for the impact of failing and the possible range of payments for success. Accounting arrangements should comply with the relevant framework and fit the nature and context of the scheme. The scheme needs to be flexible and robust enough to work in a range of future circumstances.
5. Effective and robust measurement and evaluation. Good quality data is crucial to a successful PbR scheme, both for setting baselines from which to assess success, and for checking performance over time to decide payments.

Chapter 1: A clear purpose

1 A clear purpose is important as it will shape design and implementation. Although there may be subsidiary objectives, schemes usually have one or more of these main aims:

- improving outcomes or service quality;
- reducing costs or improving value for money; or
- stimulating innovation or transformational change.

2 It may be too ambitious to try to achieve all of these aims in one PbR scheme. The challenges associated with designing the scheme to achieve the right balance between risk, cost, change and outcomes vary with different aims. In some cases, it will take a long time to show how successful the scheme has been at achieving the aim. The financial aims and planning for PbR need to take account of this timescale.

3 We have set out below the opportunities each aim presents, as well as the common pitfalls and risks and how to avoid them. The lists are not exhaustive, but they raise issues that commissioners should always consider.

Improving outcomes

The potential benefit

4 PbR is a way for commissioners to use financial incentives to stimulate greater effort to improve services and outcomes. Directly rewarding improved outcomes should encourage providers to increase efficiency; tackle difficult challenges; or make innovative or transformational changes that lead to better services, or meet customer needs more directly.

5 The required outcomes influence how the scheme needs to be commissioned and by whom. If the outcomes are affected by other public, private or voluntary services, then those bodies may need to be joint commissioners. There are several ways of approaching joint commissioning, but it will be important to make sure the rewards can be shared equitably, as well as the costs and risks.

Table 1: **Improving outcomes – common pitfalls and risks and ways of avoiding them.**

Common pitfalls and risks	Ways of avoiding them
Outcomes are not always easy to define or measure and the importance of process measures, such as waiting times for assessments, does not necessarily decrease with the increased emphasis on outcomes.	Use a small set of performance measures chosen from a wider range of input, process and outcome measures. Relevant process measures can sometimes be used as effective proxies for outcomes, or can be important in their own right.
There can be a significant delay before outcomes can be measured. This could impact on payment schedules, provider cash flow and market entry.	As well as using some process measures as proxies for outcomes along the way and paying against achieving them, consider the proportion of the overall payment attached to the outcome measures. Also, consider using sources of financing, such as Social Impact Bonds (SIBs) or claw back mechanisms that can help with provider cash flow and market entry.
Improving services and reducing demand through better prevention are not the same. Better outcomes can actually increase demand for services.	Be clear what role, if any, a move to prevention will play in the new service and model its impact on demand over time. Even if you are paying for outcomes, continue to collect and monitor important input and process measures, such as service volumes, and have other contract mechanisms in place to control these.
When multiple providers are involved in jointly delivering a service, it can be difficult to match the rewards to the contribution of each provider. The same is true for joint commissioners.	It is tempting for commissioners to leave this to prime providers, but commissioners should clarify at the start how contributions and rewards will be shared, and build this into formal agreements.

Reducing costs or improving value for money

The potential benefit

6 The drive for improved productivity, better value for money and delivering better services with reduced resources, is a significant challenge for local public services. Well-designed PbR schemes should provide councils with an opportunity to reduce the cost of a service, or improve the outcomes, for the same or less cost. Decommissioning existing services presents an opportunity to save money and this may be the scheme's specific aim. This may be possible because demand for the service falls, or a different, cheaper service delivers the same, or even better, results. PbR should give providers an incentive to be more effective, because it pays according to how well they perform. Some PbR schemes bring in new funding to support change, such as SIBs. This external funding allows the commissioner to continue using its funds to keep the service going, while investment is put into the new approach. When the benefits, such as reduced demand, are realised, the savings made will offset the return on investment paid through future payments for success.

Table 2: **Improving value for money – common pitfalls and risks and ways of avoiding them**

Common pitfalls and risks	Ways of avoiding them
Poor scheme design or unanticipated overperformance can result in higher than planned reward payments.	Model a number of different likely scenarios, with varying levels of performance and reward, to predict how and when overall costs may rise.
Failing to make proper provision for costs to be incurred later by deferred outcome payments.	Identify and understand costs over the whole life of the project, including any residual liabilities. Ensure these are reflected properly in financial planning.
Disputes about levels of achievement and consequent reward payments could lead to protracted negotiations or even expensive litigation.	Set out clearly at the start who has the final authority to decide on levels of achievement. Consider the use of a neutral third party in confirming levels of achievement or in resolving disputes.
Not planning for significant failure and the costs of service reinstatement or compensation/litigation costs.	Consider asking providers for a bond to underwrite their performance. Have a plan for service continuity in case of failure.
Not planning for the costs of decommissioning, including effective communication with service users.	Take a whole life view of the impact of decommissioning services. Model the costs of both decommissioning and changes in the volumes of service users. Involve service users in the design and commissioning of the new service.
Savings for one organisation can lead to extra costs for another.	Whether jointly commissioned or not, involve other stakeholders in decision-making about how to share savings and productivity gains.

Stimulating innovation and transformational change

The potential benefit

7 Using PbR to encourage innovation can mean giving the provider greater freedom to do what they think will work. By specifying outcomes, rather than processes or particular ways of delivering services, PbR can allow providers to try new ways to achieve the desired result. Some of the current government schemes take this approach and invite bids from provider organisations to say how they will deliver the outcomes. If this is successful, the commissioner will benefit from a new approach that might not be tried through other payment schemes. Commissioners will also, if they have designed their scheme well, have taken on less of the risk of trying something different.

8 Pooling resources across organisations may create an opportunity to share costs and savings and deliver outcomes more effectively. By broadening the scope of the scheme, commissioners can also spread the benefit of achieving the outcomes – and the investment. By sharing risks and benefits in this way, barriers to single organisations investing alone may be overcome, allowing room for schemes that have previously been considered too high risk. Some councils taking part in the community budget pilots (Ref. 2) are exploring how to use PbR commissioning to get the greatest all-round benefit.

Table 3: **Stimulating innovation – common pitfalls and risks and ways of avoiding them**

Common pitfalls and risks	Ways of avoiding them
The greater the degree of innovation required, the higher the risk to the provider and therefore the larger the expected reward.	Plan carefully to balance the financial and practical risks and opportunities. Consider providers' track records in innovating successfully. Also, think about how the knowledge gap can be reduced through careful piloting and evaluation.
For some services, it is not innovation that is required but adherence to best practice.	In such cases, outcome measures may become less important than input and process measures. However, commissioners can still attach more explicit financial rewards to improved performance, as in payment for performance schemes.
Not budgeting appropriately for the impact of moving from reactive to preventative action.	Carefully model changes in demand for reactive services as preventative services come online. Be realistic about the scale of reduction in demand needed to close whole facilities and release costs. Monitor actual changes and adjust medium-term finance plans accordingly.
Differences between information and finance systems can be a barrier to joint working.	At the planning stage, specify and agree shared information requirements, including quality assurance and reporting arrangements.
Not planning for the costs of joint governance arrangements or considering cultural/priority differences between organisations.	Be clear who is responsible for what and how partners will work together.

Chapter 2: Understanding risks and accountability

Risk transfer

9 All PbR schemes allow commissioners to transfer practical and financial risk to providers. By linking payment to defined results, commissioners ensure they do not pay for poor performance.

10 The provider or a third-party investor may be expected to cover, at least in part, early start-up costs, such as buying or refurbishing assets, or early running costs until payments for success cover outlay. This transfers the financial risk of setting up a new scheme from the commissioner to the provider.

11 Some schemes rely on funding from third-party investors (see Chapter 4). The payments for achieving success provide the return on their investment. Providers in the private, voluntary or social capital sectors may see an opportunity to invest in new approaches to services and potentially reap the rewards of doing so. This can allow investment in new approaches without commissioners needing to find new money from budgets already under pressure.

12 It is not possible to transfer all risk – reputational, practical or financial. Commissioners need to understand the extent to which risk will transfer and how to mitigate those risks that remain. It is essential to consider what would happen if the scheme fails, or only partially succeeds, or succeeds too well (for example, the payments might appear too generous in retrospect). Risks of a negative impact on citizens and service users, especially the most vulnerable groups, should be considered. Elected members are likely to be held to account for poorly performing local services, or poor financial deals, no matter what the nature of the agreement. It is essential to consult them fully on the risks and issues before taking a decision to proceed with a new form of commissioning.

13 Local people will also feel the impact if the PbR scheme fails. For some services, failure to deliver will leave councils at risk of not fulfilling their legal responsibilities. For example, if a PbR scheme intended to prevent homelessness failed, the council would still need to assess applicants and find accommodation for those covered by the law.

Market and commissioning risks

14 There are risks relating to competitive markets and commissioning that need to be considered and reflected in PbR scheme design.

15 Commissioning for PbR is more complex than traditional procurement and carries more risks. Expert commissioning is crucial to the success of a PbR scheme and will help to avoid delivery failure, increased costs and disputes about achievements and payments. PbR requires technical skills to negotiate and deal with the financial and legal issues around contracts, including design and handling variations and disputes. The extra work and higher levels of expertise needed may also add to costs.

16 Because it is based on risk transfer and financial incentives, PbR needs a clear separation between the commissioner and provider. Commissioners can still work in partnership with both potential providers and with service users, or beneficiaries, to shape the service. But responsibility for the results must transfer to the providers.

17 Commissioners, providers and investors need to be clear who is taking on the risks associated with a scheme and that any transfer of risk is contractually sound. This will be particularly important if there is a plan to involve a third-party investor, for example through an SIB (see Case study 1 and Chapter 4).

18 The approach to commissioning needs to match the overall approach, reflecting the purpose and objectives, responsibilities, accountability and measurement issues. Letting effective PbR contracts needs to balance the interests of providers and private investors with those of commissioners and service users. Commissioning for PbR needs the right levels of skills to:

- understand customers (the target population) well and, in particular, to understand their needs for outcomes rather than service delivery;
- understand the market capacity and willingness to deliver the requirements, including the available skills and expertise and the degree of competition; and
- procure effectively – getting the scope and scale right to attract bidders; creating a clear, fair and accessible process; balancing risk, reward, affordability, accountability and clear outcomes in the contract specification.

19 The nature of the risks will depend on the capacity and readiness of the market to provide competitive offers to deliver the contract. In particular, it is essential to have enough providers with the capacity, capability and desire to make competitive bids for the work.

20 The payment and reward structure can help or hinder market entry for smaller enterprises, including social and voluntary providers. The scale of ambition, both for the extent of change and the volume of service, will also have a bearing on who can compete.

21 Understanding the risks related to market behaviours is also important for successful PbR schemes. Having a financial stake in claiming credit for outcomes may tempt providers to seek reward for the results of others' actions. This is more likely where there are competing providers, so clarity about target population, cause and attribution are important if this is the case.

Accountability

22 Accountability arrangements need to be clear and robust enough to provide assurance to both commissioners and the public. Locally, the commissioning body needs to be clear who is ultimately responsible for overseeing the arrangements. A council commissioning a single service could simply use its existing accountability arrangements. This may be the cabinet or executive member, or a senior council officer. Responsibility for operations is likely to be with the providers, monitored by the commissioner.

23 In general, the commissioning body needs to ensure that it:
- has the appropriate controls and assurance, including financial and governance arrangements, and means of redress, in place;
- has clearly set out the role of independent audit and scrutiny in relation to the PbR scheme
- has accountability arrangements that fit local needs and context, and reflect the funding arrangements; and
- has clear measures that suitably reflect the outcomes it wishes to achieve.

Case study 1

Peterborough reoffending pilot

How it is possible to use commissioning arrangements to transfer risk away from the commissioner, though some risks will remain.

Context: Sixty per cent of short-sentence prisoners reoffend within a year.

Investment in more effective rehabilitation requires funding but can take time to have the scale of impact needed to make real savings by closing prisons.

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To address this funding gap, Social Finance set up the first SIB in the UK to channel funding into more intensive rehabilitation services in Peterborough. Social Finance raises funding from several 'social investment' organisations. The return on investment, paid by the Ministry of Justice (MoJ) and the Big Lottery Fund, will relate directly to the results achieved.

Target population: All male prisoners leaving HMP Peterborough within a defined period, starting September 2010, who have served a sentence of less than 12 months.

Approach: Experienced social sector organisations will provide intensive support to 3,000 short-term prisoners over six years, both inside prison and after release, to help them resettle into the community. The social investment funds pay for these organisations to deliver the service, regardless of outcomes.

Payment scheme: If this initiative reduces reoffending by 7.5 per cent or more, the government will give investors a share of the long-term savings. If the SIB delivers a drop in reoffending beyond the threshold, investors will receive an increasing return up to a maximum of 13 per cent.

The MoJ has commissioned the RAND organisation to evaluate the Peterborough pilot (Ref. 4). The MoJ published the first, interim report, covering the planning and implementation stage of the project in May 2011. Among other issues, this highlighted the transfer of risk within the scheme. It found that those involved believed financial risks had been successfully transferred from both the MoJ and the small providers to the private investors, although this risk has yet to be tested. All parties felt they bore some reputation risk from participating in the world's first SIB. The providers are paid upfront and not by results (it is the investors that are paid by results), so RAND concluded the reputation risks may provide an important motivation to perform well.

The commissioning arrangements also reflect this. The report concludes that in other payment-by-results arrangements, government has tended to maintain some control over the selection of providers. In the Peterborough SIB, the government leaves that selection to an intermediary (such as Social Finance in the Peterborough SIB) and has no direct relationship with the service provider.

24 For joint commissioning, the accountability arrangements will be more complex, but experience from previous joint working will be useful. Community budgets provide one opportunity to address these issues. By pooling resources locally, they create a need to identify priority outcomes and bring local bodies together to tackle difficult challenges. PbR's focus on outcomes may help partners to overcome any cultural or procedural barriers that could arise if the focus was more on process, or on particular models of delivery. Partnership working can bring added costs as well as benefits (for example, extra communication and relationship management as well as aligning systems between partners). These costs must be weighed against the expected benefits and reflected in budgets.

25 Pooling resources and accountabilities requires clear legal powers and responsibilities for commissioning bodies. For councils, the Localism Act's 'power of general competence' may make this more straightforward (Ref. 5). Councils and other local bodies will need to ensure they have the legal powers to enter new arrangements, including new financing arrangements such as SIBs.

Chapter 3: A well-designed payment and reward structure

26 A carefully planned and robust payment and reward structure is crucial to the success of a PbR scheme. Any PbR scheme design has three main elements, which can be combined in various ways:

- the balance between core payments and reward payments that depend on outcomes;
- how and when to pay; and
- the incentive for providers.

27 The sections below set out what commissioners need to consider as they plan their PbR scheme.

Approach to core and reward payments

28 Some schemes are designed with all the payment to the provider depending on outcomes, while others put only a small proportion of payment at risk. Others vary the proportion of payment based on outcomes during the contract life – for example, beginning with a fairly small performance element to recognise start-up costs for the provider, and then increasing the proportion as the new arrangements settle in. Views differ on what works best and the evidence is not conclusive, so it is a matter of choice and careful design to reflect the objectives.

29 Commissioners will need to weigh up the pros and cons of different levels of payment by results. If a scheme links all payment to results, the risks for the provider may be very high, possibly discouraging some from bidding. Small providers, including voluntary organisations or small businesses, may not be able to carry the financial risk of failure if the amount of money at risk is very large and so may not bid to provide services.

30 Small financial incentives can have large positive effects, so it may not be necessary to put all the payment at risk. Some existing schemes have as little as 1.5 per cent related to performance. However, these may not focus sufficiently on outcomes to reflect a genuine payment by results approach, or transfer enough risk and reward to achieve the underlying objectives. Where early investment or other costs of entering the market are high, the payment structure should give both assurance and incentive to providers. This means getting the right balance between core payments (those not related to outcomes) and reward payments. Each scheme design will need to take account of the market, the level of risk transfer and investment needed, as well as striking the right balance for the local context.

Case study 2

The Work Programme

How payment and reward schemes can be designed to incentivise providers.

The Work Programme is central to the government's plans to reform welfare-to-work provision in the UK. It aims to streamline a wide range of schemes to help and support people back into sustained employment. The scheme is not prescriptive about how providers should do this, but allows flexibility to design support based on customer need, reward providers for keeping people in work and for helping harder-to-help customers. It is still in an early stage of implementation, so its effectiveness is so far unknown.

The Work Programme shows how payment and reward scheme design can support objectives, by varying payments to reflect different degrees of difficulty (to discourage 'cherry-picking'). The approach to reward payments aims to get more customers (including the harder-to-help) into work than ever before, and keep them there. The pricing model is designed to incentivise providers to do this. There are three main payments:

- an attachment fee, to assist with initial service delivery costs;
- a job outcome fee, to reward providers for getting as many customers as possible into work, and
- sustainment payments, paid to the provider while they keep a customer in work.

The scheme also highlights a key design principle of limiting overall reward if cost constraint or savings are important:

'The price paid for employment outcomes should be set to make it worthwhile for delivery partners to help each group of customers; and the price paid for job outcomes should not exceed the benefit savings that have been generated.' (Ref. 6)

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This approach contrasts with the Peterborough reoffending pilot, where a third party funds the providers. In that case, there is no equivalent of the ‘attachment fee’ and commissioners do not pay the funders until the required results have been delivered. The payment and reward structure should reflect the circumstances, aims and provider market relevant to each PbR scheme.

How and when to pay

31 Commissioners’ main options for organising payments to reflect performance are:

- payments for results achieved, possibly in the form of bonuses;
- repayments from the provider for missed results;
- withholding planned funding, with payment conditional on achieving the specified results; or
- a combination of any, or all, of these.

32 Repayments, or withholding planned funding, are considered less often than extra payments for performance, but can have strong motivational effects on providers. Some commissioners include a maximum payment (cap) in their contract with the provider, to ensure that a very successful scheme does not cost more than they are able to pay. Similarly, a guaranteed minimum payment (floor) may help reduce the risk for providers. Together, caps and floors can be helpful where there is significant doubt about the likely level of achievement.

33 In the contract, the commissioner needs to be clear about how they will attribute success and share out reward payments to different providers. They need to be aware of situations where they pay for the results but other organisations benefit from the same results, and seek to share some of the costs.

Incentives for providers

34 The payment scheme needs to be attractive to providers and incentivise them to deliver the best outcomes they can.

35 The timing of payments can affect the incentive for providers to bid. The initial investment needed to set up or transform delivery, and the expected payback time for any savings from improved outcomes, should be considered together. The outcomes from some schemes may take years to deliver, but some providers may not be willing, or able, to wait this long to be paid.

36 Commissioners must factor such timescales into their planning. Reward payments may be at fixed intervals, based on results in the period (such as quarterly or annually), or triggered by when the results are achieved. Commissioners will also want to be confident that improvements delivered can be sustained beyond the contract term, particularly if services are decommissioned.

37 Public reporting can be used to encourage providers to perform well (Ref. 7). Publishing results can provide a powerful, competitive nudge to providers. Commissioners would need to make this a contractual requirement to guarantee publication of specified information and within a set timescale. This may not be popular with providers, but this public sharing of information is in line with current expectations of greater transparency and accountability for publicly funded services.

Minimising running costs and administration

38 The potential rewards need to reflect the extra costs of taking part in a PbR scheme. If running costs (relating, for example, to the measurement issues in Chapter 5) are high, this may limit interest from providers, and the scope for overall savings.

39 The scheme design should reflect these timing issues and running costs. They will affect decisions on the balance between fixed and performance-related payments.

Chapter 4: Sound financing

Available or potential sources of finance

40 In this chapter we look at the different financing options available when setting up a PbR scheme. There are many sources of finance for PbR schemes, including:

- mainstream funding;
- traditional loans;
- pooled (including community) budgets;
- charitable or social investment (such as SIBs);
- private investment; and
- providers funding themselves until they get reward payments.

41 The type of funding will affect financial planning. If using existing or pooled budgets, these will need to reflect when payments are due. Loans carry risks if variable interest rates exceed projections, or if returns do not cover repayments. Strong medium-term financial planning will also need to include reasonable assumptions about reward payments. This should cover the range of circumstances from very low performance to very high and include contingency plans for changes in the external context, which might affect results.

42 If using external funding or self-funding providers, then the timing of payments will need to reflect a balance between risk and potential return on investment to make the offer sufficiently attractive. One way to avoid the need for working capital and early investment being a barrier to small enterprises is to use a third-party investor who will take the risk for a return on investment later.

43 Commissioners will need to consider the available range of choices and use their professional judgement and local circumstances to decide which is best for a specific scheme.

Profiling funding across a range of circumstances

44 Funding needs to be enough to cover:

- the early costs of commissioning and continuing monitoring and review,
- any start-up or early investment costs or decommissioning costs, including eventual close-down costs;

- continuing running costs and reward payments, allowing for a suitably attractive return on investment;
- contingency plans for dealing with failure; and
- residual liabilities (anything required beyond the direct cost of the PbR scheme – see 'common pitfalls and risks' in Chapter 1).

Responsibility for securing funding

45 The scheme should clearly set out who is responsible for securing what funding over what timescale. Profiling funding requirements throughout the scheme is an important part of design. To consider the overall impact on public spending, the commissioner should take into account any cost implications for other bodies outside the scheme. The funding also needs to be both robust and flexible enough to cover a wide range of possibilities. As reward payments are by nature unpredictable, commissioners should profile different projections covering the full scope of possible funding needs.

46 SIBs are one way of funding PbR schemes. They differ from other financing options in that a third-party investor provides the funding for the scheme, rather than the commissioner. SIBs could be considered where there is confidence that PbR is the appropriate approach but where the commissioner is unable or unwilling to provide the finance.

47 The organisation Social Finance defines SIBs as 'a form of outcomes-based contract in which public sector commissioners commit to pay for significant improvement in social outcomes . . . for a defined population'. Social Finance states that SIBs are used to attract new, private, investment and provide a return from public funds. This return is linked to improved outcomes resulting from the investment. SIBs can therefore fund early investment or preventive work. They also transfer risk as the return on investment is not achieved if the outcomes do not improve enough.

Accounting

48 PbR schemes have no special accounting rules. Commissioners should refer to the current relevant accounting framework, which, for councils, is CIPFA's Code of Practice on Local Authority Accounting (Ref. 8). The nature and circumstances of each scheme will decide its accounting treatment. Commissioners may want to seek professional advice when considering how to account for the different elements of their scheme. These may include, but may not be limited to, the following:

- interest held, including any held through any special arrangements set up;
- set-up costs, or transfers of assets;

- interim and final reward payments (including provisions for possible future payments);
- assets used to deliver services;
- leasing arrangements (or similar) that support delivery; and
- residual interests and liabilities on completion or early closure.

49 There may also be accounting implications for any entity or special purpose arrangement set up to deliver the scheme. However, this will depend on the nature of the entity and any particular financial reporting requirements that apply to it. Again, it may be advisable to seek professional advice at an early stage when designing the scheme. Discussing the plans with the external auditor at an early stage, so that the auditor can consider any implications for audit planning, is advisable.

Chapter 5: Effective and robust measurement and evaluation

50 The ability to measure and evaluate outcomes and the overall success of the project is the essential ingredient for a successful PbR scheme. PbR can only succeed with outcomes that can be accurately measured to inform payments, so success measurement and evaluation cannot be left until the scheme is up and running. It is not advisable to begin a PbR scheme unless good quality data is available to help inform decisions about payments. It is also important to be able to allow for changes in outcomes that could happen anyway.

51 Openness with data is also important, so that performance is visible. This will also help build trust between commissioners and providers. There may be significant differences between the data available to commissioners and to providers, but both need access to the same data used to decide payments. The need for reliable, good quality data may increase the overall cost of the project.

Establishing a baseline

52 Setting an agreed baseline and suitably rewarding success both depend on having enough reliable evidence about the outcomes and other measures. Relevant, robust and available information should be used when assessing the outcomes that shape a PbR scheme. Together, the metrics used need to be broad enough to give a rounded picture without overcomplicating matters, or diluting the intended impact.

53 Data will be required at the start of the project and at key milestones throughout the project when outcomes are measured. It should genuinely reflect those outcomes. If collecting reliable direct data on the final outcome is not possible, commissioners may use proxy measures, if they are confident these are genuine and reasonable. For example, those involved in the Peterborough reoffending project agreed to use reconviction rates, because reoffending rates are more difficult to measure accurately.

54 The people intended to benefit from the service delivered by the PbR scheme should be clearly defined. This group can then be used to track future progress. The data collection also needs to identify and define subgroups. This helps avoid providers 'cherry-picking' the easiest and cheapest groups or individuals on which to focus their efforts to improve outcomes. If this happens, outcomes will be inequitable as the more difficult people to deal with, such as those with the most complex or challenging needs, will be left out, unless the commissioner picks them up, with greater unit cost. Using services to prevent reoffending as an example, the commissioner would need to understand how likely the target population and sub-groups within it are to reoffend. Preventing service providers from targeting only those statistically less likely to reoffend means specifying clearly what outcomes you require, across which population.

55 Another danger, if the target population is not defined clearly, is that providers may do only the minimum for those people most difficult to make progress with. This is sometimes called 'parking', because it puts off dealing with the most challenging, or expensive, service recipients.

56 Payments must align with the data. This may require the development of a classification scheme. These need not be overly complex. They will often be based on needs or interventions. So it may be necessary to collect some input and process data to construct a classification scheme.

57 Other influences on outcomes that occur separately from the provider's actions, but may affect results, should also be considered. For example, a general increase in economic wealth may have more impact on reducing unemployment than a targeted employment support scheme. Similarly, changes in the target population, or social and demographic changes, may also affect outcomes. Projections that allow for a reasonable range of circumstances can help make sure the arrangements can take account of these external factors.

58 Control groups can allow comparisons of how outcomes change for comparable populations not covered by the PbR arrangement. This will help decide whether the interventions are succeeding or whether the changes would have happened anyway. Using control groups has, for example, helped to show that seemingly successful schemes designed to reduce hospital admissions have, in fact, fared no better than existing services (Ref. 9).

59 Peer groups can be used to help judge performance in a competitive scheme. In such a scheme, the reward payment is dependent on where a provider scores in a ranked list of peers. Such an approach requires a mature approach to sharing performance data and high levels of coordination between commissioners. However, it has been made to work successfully in pay-for-performance schemes, with as many as 250 providers or 24 commissioners. Research also suggests that competitive schemes can provide a greater incentive to providers than one-on-one contracting arrangements.

60 As well as relevant outcomes and the target population, the baseline data needs to include the initial costs and other inputs.

61 Good quality data supports clear accountability within PbR. It also has added benefits in helping to improve management, planning and service delivery. The Audit Commission has previously defined good quality data as being 'accurate, valid, reliable, timely, relevant and complete' (Ref. 10). The need for good data may create extra costs. These may come from measuring, collecting and analysing, but also developing information skills and capacity. However, poor data could easily lead to inaccurate calculations or incorrect payments, which could also be costly.

Getting a balanced view

62 A balanced range of measures is important. Overreliance on a single or small number of measures could lead to 'gaming', with unwanted effects and perverse incentives. What is measured and paid for will be what gets done. The target population and outcomes should be tightly specified. Poor definitions, or too narrow a focus could, for example, tempt providers to reduce important aspects of service. An example of this would be an outcome to reduce the numbers of people in care homes, without setting clear criteria about quality of life and care, or other issues.

63 Conversely, overcomplex measurement requirements may be a disincentive to providers, because of higher administration costs. A hierarchy of measures and payments could also encourage providers to focus on those metrics that have more impact on the reward payments, at the expense of others that may be important to users or commissioners.

64 Commissioners should design PbR scheme measurement with care, to encourage the right behaviour and ensure fair attribution of rewards to providers in the simplest way they can. Developing the data, and the payment model linked to it, can involve considerable analytical resource and should be a factor in considering whether and how to set up a scheme.

Linking actions to results

65 It is critical that improvements can be attributed to the actions taken by the provider of the service, so that performance-based payments fairly reflect the actions taken. Confidence that these links are direct will be greatest where there is already evidence to show that the proposed actions will achieve the desired results. A lack of such evidence brings risks for both commissioners and providers.

66 The strength of the evidence for the relationship between certain actions and outcomes is crucial in selecting areas for PbR and designing schemes. For example, there is good evidence about how to help people stop smoking and how to test for success over a reasonable period. In these circumstances, designing a PbR scheme would be relatively straightforward.

67 More complex relationships between specific actions and, for example, multiple deprivation and various social outcomes, are harder to identify. Efforts to reduce teenage conceptions are an example of this. The reasons for high pregnancy rates are complex and not well understood and there is limited evidence on the efficacy of specific interventions. Attributing any decrease to particular providers is difficult, as it needs multi-agency effort and may also be affected by unconnected factors such as demographic change.

68 The strength of the evidence for specific interventions, and data availability to check progress, varies. This is a particular risk in setting up PbR locally. Individual councils may lack the resources to gather new evidence or commission local research, restricting them to areas with existing research. Also, setting up the necessary performance monitoring in an individual council may be uneconomic, or may result in transactional costs that outweigh the benefits. Higher transactional costs are likely under PbR, in part because of the need for robust measurement throughout the contract period.

69 Understanding the relationship between inputs, outputs and outcomes can help with both the design of the PbR scheme and the monitoring arrangements. Experience of PbR suggests this is necessary for effective schemes. However, sometimes a proven relationship between a specific action and the outcome may be contrary to a wish to focus solely on achieving outcomes without prescribing how. Where the wish to stimulate innovation is important, other ways to show a clear link between the providers' actions and the outcomes are necessary. It may be possible to measure progress towards outcomes by achieving milestones (important stages towards delivery); staged improvement (defined steps towards the outcomes target); and thresholds (passing levels of improvement below the target, but heading towards it). Another approach might be to use proxy measures of performance. Using approaches like these means providers can be rewarded for taking the right actions until there is clearer evidence of achieved outcomes. Providers are likely to want to record inputs and outputs for their own management and other reasons. So it should be possible to build in information sharing agreements, while keeping rewards or penalties based on outcomes.

Verifiable results

70 Our experience of auditing data quality shows that it is highly variable and that unreliable data brings high risks of poor decisions (Ref. 11). All parties need to have confidence in the quality of the data, and external assurance can be useful. Having suitable metrics that are already quality assured, or independently verified, will help. If this is not possible, independently checking the data used to set baselines and work out payments or repayments can help avoid disputes. Without this, there is a much higher risk of dispute over payments, doubt over what is achieved, and gaming to seek unwarranted (or at least unproven) advantage.

A whole life, whole system approach

71 Effective measurement can help create a PbR scheme that works for the commissioner and the provider. But a broader approach is needed to avoid deferring costs, or simply passing them on to other parts of the public sector. The Community Budget pilots are developing new ways of looking at 'whole-system' approaches to public services. Evaluation of these may provide some useful learning for how to do this effectively.

72 A whole-life, whole-system approach can bring benefits for a range of organisations, for service users, and for the taxpayer. For example, investment to reduce smoking may save the NHS money; reduce demand for care services (saving councils money); reduce benefit claims (saving DWP money); and potentially produce other incidental benefits. A whole-life, whole-cost value for money assessment would take account of all these impacts, but one organisation will find it challenging to achieve this alone. It may need measures that are sensitive enough to show early signs of improvement. For example, rewarding shorter-term proxy measures that will lead to later benefits, such as smoking cessation, is much more straightforward than directly rewarding the longer-term benefits.

Case study 3

Manchester City Council

Using cost-benefit analysis to test how partners can share both contributions and savings from applying prevention-based approaches at a significant scale.

Manchester City Council is considering using a model of public sector reform to transform services to complex families. This will include:

- improving value for money through earlier intervention and prevention leading directly to cashable savings;
- moving towards a more 'whole-system' approach to public services; and
- changing attitudes away from a 'dependency culture' to much less reliance on public services and permanently reducing demand.

As part of the strategy to improve value for money, the Council is designing payment by results models. These will:

- transfer risk;
- test innovative approaches;
- bring in investment funding; and
- create better incentives on certain outcome measures.

Manchester City Council is exploring this as part of a community budget pilot and seeing PbR as an incentive to bring together and focus efforts across public services. It is developing a new partnership contract model. Using a cost-benefit analysis method, adapted from a model developed in the USA, partners in Manchester plan to work out true overall costs and match savings from the results delivered against these. 'Investment agreements' between partners will identify how to share both contributions and savings.

Early work in two neighbourhoods of the city has showed that scale matters. They aim to achieve a step change so they can decommission whole service units, something that is not possible when small pilots deliver changes for a few families.

The initiative started within the Council, where £37 million from children's and adults' services budgets was brought together into a single budget, the Manchester Investment Fund. This will fund investment in new delivery models. As those new interventions reduce demand for services and enable them to be decommissioned, the Council can replenish the fund. As an incentive, services will be able to share some of the resulting cashable savings.

73 Some experience from private finance initiative schemes has suggested lifetime costs can be significantly higher than more traditional approaches, even though the schemes delivered shorter-term savings and new investment. Taking account of long-term costs is therefore important at the outset, so the scheme is designed to be cost-effective overall.

Chapter 6: Conclusions

74 PbR is a potentially useful approach for local commissioning and may provide opportunities for councils to find new ways of managing financial pressures and transforming services. As well as focusing on achieving desired outcomes it may:

- help transfer financial and operational risks to other organisations;
- defer costs to allow time to realise the benefits of change and preventive work; and
- encourage new ideas, new forms of service delivery and new entrants to service provision.

75 Many areas are potentially suitable for PbR. National schemes to extend its use are developing quickly. Some of the early ones include: reducing reoffending; diverting young offenders from custodial sentences; getting the unemployed back to work; preventing children from being taken into care; keeping frail older people in their own homes; and improving management of chronic health conditions. The aim is to make savings or improvements by focusing on rewarding particular outcomes in these areas.

76 The areas of activity that are suitable for local PbR schemes may vary from place to place, so local context and priorities should be considered. Because of this there can be no definitive list, but services that have the following characteristics will be more suitable for a PbR approach:

- a clearly defined target population (service users);
- clearly defined outcomes or other desired results;
- the means to measure the baseline performance and future changes;
- a reliable way of attributing changes to particular provider actions;
- providers able to deliver the required results for a competitive price; and
- enough funding to cover all costs across a range of performance outcomes.

77 However, schemes that make a large part of the payment dependent on performance are still largely untested and their overall effectiveness is not yet proven. Designing and delivering PbR schemes needs extra care and diligence to manage the risks and deliver the benefits.

78 In particular, well-designed PbR needs:
- to be the right approach to address the need and fit the local context;
- clear contractual arrangements that set out financial and practical responsibilities, payment details and progress monitoring, and explain which organisation carries which risks; and
- a payment scheme that avoids perverse incentives, supports the outcome objectives and balances risk, reward and payment timing.

79 It needs to be supported by:
- careful planning to ensure the scheme is flexible and robust enough to work in a range of future circumstances;
- good quality data, measuring the right results effectively, and available in a timely way at the start and through to the end of the scheme; and
- high-level commissioning skills to design and deliver the schemes.

Appendix 1

Glossary

The terms below have the following meanings when used in this document:

Commissioner	The body, or individual, responsible for specifying and letting a contract.
Decommission	Stop providing a service, part of one, or a facility used to deliver a service.
Input	Resources put into providing a service such as staff, premises, money or service user need.
Output	What the service activity produces.
Outcome	The impact the service has – what difference it makes to people or places.
Market	The range of organisations potentially interested in delivering a contract.
Metric	Quantitative measure.
Milestone	A key stage or event in a project or contract.
Provider	An organisation or individual that delivers a service or action.
Proxy measure	A measure that has a known, close relationship with another factor, usually one that cannot be measured directly.
Reward payment	Money paid to a provider (or possibly a third-party funder) that is directly related to the level of success achieved in the specified performance.
Transactional costs	Ongoing costs that are incidental to the main delivery of the contract, such as the cost of monitoring data or reporting performance.

Appendix 2

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