

# *Understanding commissioning behaviours*

Commissioning  
and competition in  
the public sector

*Report for the Office  
of Fair Trading*

*March 2011*

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# *Foreword*

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## *Foreword*

PwC would like to thank the Office of Fair Trading (OFT) for the opportunity to undertake this timely piece of research, looking at commissioning and competition in the public sector.

The issues highlighted in this research go right to the heart of many the most important questions facing decision makers today across government and the wider public sector. Understanding how to commission and procure public services in a way that promotes competition and innovation in the private and third sectors and achieves value for money for taxpayers is central to both the government's public sector reforms and the UK growth agenda.

The findings presented in this report provide a base of evidence to complement the OFT's own assessment of these issues. Any views represented in the two reports remain those of the respective organisations.

As an adviser to a large number of public and private sector organisations, PwC works across many of the areas discussed in this report. Throughout we have sought to present an objective view of the evidence gathered from a review of literature and interviews with a wide range of people involved in public sector commissioning and procurement; we highlight where the views expressed are those of interviewees.

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## *A. Executive Summary*

# Executive Summary

*For all of the focus on the structure, governance and operation of commissioning and procurement, the success of attempts to create open, dynamic and competitive markets often comes down to the behaviours of the individuals involved. In turn, behaviours are influenced by objectives, incentives and skills. Greater emphasis on these behaviours is likely to help the public sector to achieve more competitive markets and better outcomes from its commissioning activity.*

## The importance of public sector commissioning

Public sector commissioning and procurement of goods and services is of significance to the UK economy. The public sector buys approximately £220 billion of goods and services each year, which accounts for approximately one third of all Exchequer expenditure and or 15% of GDP<sup>1</sup>. As a result the way in which the public sector commissions and procures these goods and services can influence the structure and nature of competition in many markets, and the competitiveness of the UK economy.

In the current fiscal and macroeconomic climate, promoting effective competition – removing barriers to entry and incentivising dynamic efficiency<sup>2</sup> in order to achieve value for money and support growth is particularly important. In addition the importance of public sector commissioning and procurement is likely to grow as government buys more services and provides fewer itself.

## This study

This study complements the OFT's assessment of the role of commissioning and procurement in the building and shaping of competitive markets.

The purpose of the PwC research was:

- To gather evidence, on behalf of the OFT, on the impact of public sector commissioning and procurement on competition and markets; and
- To assist the OFT identify practical insights that can be used by public sector commissioners and procurers on how best to promote and sustain effective competition, and thereby create dynamic,

open and contestable public services markets in which commissioners, procurers and suppliers alike face appropriate, aligned incentives to achieve and sustain value for money.

The findings presented in this report are based on a literature review, a survey of 30 people involved in public sector commissioning and procurement and a study of six in-depth case studies covering areas, such as welfare, justice, health, education and pensions. The survey and case studies incorporate the views of buyers, sellers and market regulators.

The work conducted by the OFT and our supporting evidence is intended to complement the efforts already underway within government to improve commissioning and procurement and to create greater awareness of the importance of using competitive markets to achieve value for money.

## Findings: Behavioural Drivers of Commissioning and Procurement

On the basis of our research we have identified seven factors that drive the behaviours of public sector commissioners and procurers; we have grouped these factors in three categories in figure 1 - personal, organisation and wider factors.

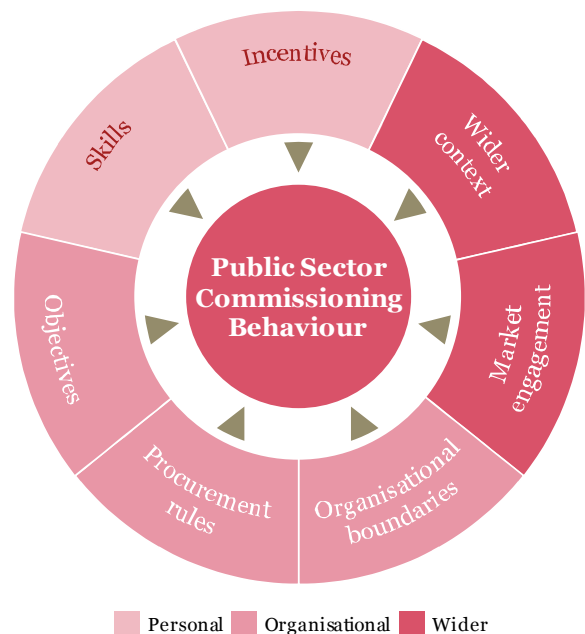


Figure 1 Drivers of public sector commissioning behaviour

<sup>1</sup> HM Treasury/Office of National Statistics Public Expenditure Statistical Analyses (PESA) 2009

<sup>2</sup> Achieving the appropriate balance between short and long-run competition, for example by investing in research and development.

## Incentives

There is a public service ethos amongst commissioners and procurers with an interest in achieving value for money for the taxpayer. However, individuals also respond to the incentives they are given, for example those relating to promotion prospects can play a strong role in influencing the outcomes of the process.

In some cases, there is a lack of alignment between public sector objectives and procurers' incentives. This appears to sometimes lead to undue focus on certain aspects of contracts (for example, the design and build phases - the outcomes of which are visible in the short term - rather than the operate phase in big building contracts). We also found evidence that public service buyers are more risk averse than might be desirable.

### Key point

People involved in commissioning and procurement in the public sector respond to incentives. The alignment of their incentives to the public sector's objectives, including those of enhancing the growth prospects of the UK economy, is important.

## Skills

Respondents said that people involved in procurement do not always possess all of the necessary skills. For example, participants reported that procurement teams used staff who were too junior to undertake important tasks and lacking in contract management skills; they also suffered from high staff turnover. There was also evidence that procurers did not have sufficient understanding of the impact of their own actions on the relevant markets.

### Key point

There may be gaps in the skills of procurers in public sector organisations. Addressing these gaps could improve outcomes.

## Objectives

When procuring goods and services, the public sector tends to have a wider range of objectives than a private sector counterpart. The public sector clearly aims to achieve value for money for the taxpayer – this applies to both the short and long-term, taking into account both price and quality.

In some markets, there are trade-offs between objectives, particularly where quality is difficult to assess and the government is a major buyer. For example, driving a hard bargain in the short-term may inhibit subsequent investment and innovation, undermining the creation of longer-term value.

There are examples of commissioners and procurers carefully thinking about these trade-offs and, for

example, focussing on the long-term development of supplier markets. However, our research suggests that in some cases not enough consideration is given to these trade-offs.

In some cases commissioners and procurers may be very focussed on short-term price to the detriment of quality, longer-term value and economic growth. In other cases they appear to be very price-insensitive and instead more focussed on particular aspects of 'quality', for example, being comfortable with the people they are dealing with.

We also found examples where the commissioners' relative weighting of objectives changed over time, causing cycles in markets that proved to be destabilising for some suppliers. However, in other cases, there appeared to be substantially more focus on longer-term market development.

In the case of competitive dialogue<sup>3</sup>, we found that some procurers appeared to be starting the formal process too early in the procurement process, without conducting sufficient research to clarify their requirements beforehand.

### Key point

Commissioners and procurers do not always consider the relative importance of different objectives with sufficient clarity; therefore commissioning strategy is not always conducted on the basis of a clear set of objectives.

There is not a single 'right answer' to the appropriate trade-off between the public sector's different commissioning objectives. In the current climate, an excessive focus on short-term price, particularly in some markets, may be detrimental to longer-term value for money.

## Procurement rules

Public sector organisations must adhere to EU procurement rules. We found evidence that in some instances an excessively prescriptive interpretation is placed on these rules. This may lead to an overly bureaucratic process, a lack of constructive engagement with potential suppliers and excessive costs which can put off some suppliers (particularly SMEs).

The interpretation of procurement regulations is often made by the organisation that procurers work for, and staff may not feel that they have the ability to adapt the approach taken to suit the specific requirements of

<sup>3</sup> Competitive dialogue is a procurement route introduced in 2006 for use in the award of complex contracts where there is a need for the contracting authority to discuss the proposed contracts with potential suppliers.

the procurement, particularly if staff are quite junior or new to the organisation.

However, a small number of respondents suggested that procurement rules are a lot less prescriptive than many people think. In some instances, there was evidence that these problems were avoided with apparent success.

It was suggested to us that the prescriptive interpretation of rules may be a symptom of an excessively risk averse culture.

#### **Key point**

Public sector organisations do not always design the best procurement process for the task. EU rules seem to often be interpreted in a highly prescriptive way. This can lead to perceived restrictions driving procurement activity, rather than the process being driven by the procurement objectives.

### **Organisational Boundaries**

We found that organisational and professional boundaries within the public sector can reduce the effectiveness of the procurement process.

In particular, we found evidence of barriers within public sector bodies between people responsible for policy/strategy development, specification, commissioning strategy and operational procurement. These barriers can lead to the actions of procurers who are responsible for evaluating and managing suppliers being very different to that which might be desired by strategy and policy-makers.

There was a reported lack of engagement and communication between the people involved, who are often from quite different professional backgrounds, in different parts of the organisational hierarchy and of different 'status' in the organisation.

#### **Key point**

There can be barriers and a lack of alignment between different people involved in commissioning and procurement within public sector organisations. There may be room to improve performance by doing more to build engagement and agree objectives between the people involved.

### **Market Engagement**

We were told that those involved in public service commissioning and procurement do not always engage fully or constructively with potential suppliers.

We found evidence of commissioners and procurers not having a good enough understanding of relevant markets. We also found that both commissioners and procurers appeared to not fully understand the impact

of signals they sent to suppliers. For example, in a number of the cases we looked at, the public sector had cancelled procurements at a late stage or ended contracts early. This had the effect of creating significant uncertainty in the market and discouraging some suppliers from participating. Whilst this type of action may well be required from time to time because of a changing political or economic environment, it was not clear that those involved fully considered the impact their decisions would have on suppliers and their willingness to participate in the market in future. It is likely that such behaviour would increase costs and risk to suppliers, therefore increasing future costs to buyers too, reducing the vibrancy of competition and possibly reducing incentives to innovate.

Evidence from the care homes market suggests that in the absence of effective market engagement, commissioning behaviours can be informed by mistaken perceptions of suppliers' capacity, views, and motivations.

Market engagement involves engaging directly with suppliers, and gathering accurate information. We found that a lack of information was a challenge for commissioners and procurers in a number of markets. For example in hospital facilities management, a lack of high quality and comparable data limits the effectiveness of benchmarking exercises. In the private sector, there are examples of industries collaborating to support information systems that offer supplier information across an entire sector.<sup>4</sup>

#### **Key point**

Commissioners and procurers could often benefit from more engagement with and understanding of potential suppliers. They could also spend more time assessing the impact of any signals they send to the market.

### **Wider Context**

The present state of the economy and the fiscal position is having a major impact throughout government, with an increased focus on price across a range of different markets. In some cases this is accompanied by a very short term focus. Both of these factors may be necessary; however, they have the potential to work to the detriment of long term competition and suppliers' incentives to invest and innovate.

More generally, the impact of wider government policies and initiatives varies. In some markets, such as, residential care and welfare to work, new policy initiatives such as payment by results, personalisation and localism are having a major effect on the shape of the market and the challenges and opportunities faced

<sup>4</sup> 'Procurement under the spotlight', Times, 10 March 2011

by suppliers. For instance, the personalisation agenda in social care is resulting in personal budgets for consumers. This can allow care home operators to engage directly with the consumer; however, uncertainty about how budgets will be calculated makes business planning difficult for suppliers and potentially undermines consumer choice, with the market effectively lacking sufficient information to respond to demand. While many of these initiatives have been welcomed by suppliers, the impact on competition often depends upon careful implementation to avoid unintended effects.

#### **Key point**

Suppliers sometimes perceive tensions between different Government policy aims. It would be helpful for Government to articulate how they fit together in order to avoid unintended consequences.

## **Findings: Other key issues**

In addition to the seven behavioural drivers of commissioning activity, a number of other issues arose from our research. In many cases they were the result of more than one behavioural driver.

### **Bundling**

The decision to bundle a range of required products and services into one aggregated contract, or to break up requirements into several distinct procurements is an important feature of many big government commissioning and procurement exercises.

In the right circumstances, bundling can bring significant benefits, reducing the number of contracts to manage and aligning incentives of those who design and build to take a full account of future operations.

In several cases, however, we found evidence that commissioners/procurers had not thought carefully about bundling and may have bundled too many different services into one contract. There appears to be a tendency for commissioners and procurers to go to market in a way that suits the few largest suppliers; this may disincentivise some of the best smaller suppliers who are unable to deliver the scale and mix of service required.

#### **Key point**

Commissioners and procurers do not always recognise that the decision over whether and how to bundle goods and services together when procuring is one of the most important in the commissioning cycle. In fact, the bundling decision can drive many key aspects of procurement, such as choice of suppliers.

### **Payment by results**

A number of the people we spoke to believe greater use of payment by results will improve the value for money achieved by the public sector and will create greater innovation in the supply of services. However, some concerns were expressed about the impact payment by results might have on SME and voluntary sector suppliers. This is because they often find it more difficult to meet the cash-flow challenges inherent in asking suppliers to bear costs well in advance of achieving the outcomes which result in their being paid.

We also noted a range of approaches being taken to the funding challenge created by use of payment by results in different parts of the public sector. For example, social impact bonds have been used to fund probation services whilst in welfare to work prime suppliers have been asked to find the upfront funding.

#### **Key point**

Payment by results has many advantages but does create significant funding challenges for suppliers, particularly SMEs and voluntary organisations.

### **Entry**

We note that there appear to be significant barriers to private and voluntary suppliers accessing some public service markets, particularly those where the public sector is the major or only supplier. We found evidence of a perceived lack of a level playing field in such areas. Where markets had been opened up to competition there was a perception of bias towards public sector supply. The evaluation of bids was not perceived to have been fair owing to differences in the treatment of tax and pensions.

Where competition does exist, we found consistent views among suppliers and others that public sector commissioning and procurement activity can create unnecessary costs and risks to suppliers. These factors are likely to affect suppliers' decisions over whether and how to participate in public service markets, potentially at the expense of vibrancy of competition and long-run value for money to taxpayers.

One barrier to entry that is sometimes overlooked is the increase to bidding costs introduced to tenders which are let close to general elections, where uncertainty about a contract's future can affect a potential supplier's decision about whether to bid.

#### **Key point**

There are still significant barriers to suppliers entering many public sector markets. Value for money for taxpayers may be improved if commissioners can identify and remove these barriers.

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## Exit

We found some evidence of public sector buyers giving consideration to the retendering of contracts and how to prevent incumbency from developing. There was also more limited evidence of provision being made for the possibility of supplier failure. For example, both of these questions were considered by the procurement team in the PADA case study. However, in general there was little evidence that these questions were explicitly addressed.

Knowing that exit is a possibility is important for creating the right incentives on suppliers to bid realistically and to maintain a high level of service, as we found in the Flexible New Deal case study.

Where considered, exit is viewed as a constraint on external involvement due to the risks presented to service continuity. This does not always have to be the case as coping mechanisms such as financial bonds or “supplier of last resort” procedures<sup>5</sup> have been developed in some sectors.

In the current economic climate, exit –either voluntarily or through failure – is a particular concern, for example in areas such as the market for residential care homes. Failure in particular is likely to become even more important as immature markets in health, welfare to work and other areas continue to develop.

### **Key point**

The exit of suppliers, either through their own failure or choice, is an important consideration that is not always a feature of procurements.

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<sup>5</sup> This is where a regulator or market maker has powers to require another provider to take over the activities of a failed provider. See page 56 of this report for an illustration of how this would work in practice.

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## *B. Introduction*

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## Introduction

Public sector procurement of goods and services is of significance to the UK economy. The public sector procures approximately £220 billion of goods and services each year, which comprises approximately one third of all Exchequer expenditure. Public sector spend often constitutes a large percentage of a given supply market. Indeed in some markets, such as health, education, justice and transport, the public sector is often the main purchaser of products from suppliers. In total, services commissioned by the public sector account for 6% of GDP and around 1.2m jobs.

The Office for Fair Trading (OFT) commissioned PwC to undertake economic research into public sector commissioning. The purpose of this research was:

- To gather evidence, on behalf of the OFT, on the impact of public sector commissioning and procurement on competition and markets; and
- To assist the OFT identify practical insights that can be used by public sector commissioners and procurers on how best to promote and sustain effective competition, and thereby create dynamic, open and contestable public services markets in which commissioners, procurers and suppliers alike face appropriate, aligned incentives to achieve and sustain value for money.

This report serves to provide an evidence base to the work undertaken by the OFT in examining public sector commissioning and competition in public services markets, and aims to support their wider advocacy work aimed at promoting and raising awareness of competition issues in government. This report is intended to be practical, rather than theoretical. The OFT and PwC hope it will be of interest and use to a wide group of stakeholders such as commissioners, procurers, suppliers and policy-makers and will serve as a useful input to the wider programme of work across government aimed at bringing about improvement in commissioning to the benefit of both consumers and the UK economy.

## Current Policy Context

Since coming into power in May 2010, the coalition government has announced a wide-ranging reform programme for public services. This has been launched alongside a range of measures to improve government efficiency, led by a new Efficiency and Reform Group in the Cabinet Office.

Many of the cross-government reforms that will have an impact on behaviour and practice throughout Whitehall and beyond (including for commissioners and procurers) will be set out in the Government's

Public Service Reform White Paper, which was announced in the 2010 Spending.

The Paper will set out more detailed plans for the Government's Big Society reforms, which aim to reform and open up public services and shift power away from central government to citizens, communities, and independent suppliers. The paper is likely to focus in detail on ways of:

- Extending innovative payment and funding mechanisms;
- Developing new rights for communities and public employees to buy and run services;
- Setting proportions of certain services that should be provided independently;
- Bringing external investment and expertise into service reform; and
- Increasing democratic accountability at a local level.

The White Paper is also expected to set out plans for taking forward the commissioning reforms set out in the Modernising Commissioning Green Paper, published in December 2010. This paper outlined the wish for government to make existing public service markets more accessible for civil society organisations.

Alongside this, the paper set out a desire for commissioners to use assessments of full social, environmental and economic value to inform their commissioning decisions and for civil society organisations to support greater citizen and community involvement in all stages of commissioning and procurement. All of these themes are likely to have a major impact on the ways in which commissioning takes place – and the behaviours that commissioners need to adopt - throughout government.

More widely, it is highly likely that the Public Service Reform White Paper will set out in greater detail the government's plans for a further change to commissioning practice, including the increased use of 'payment by results' (PbR), where payments are linked to outcomes instead of inputs. This is seen by government as a key means to increase competition, and consumer choice. It is hoped that a focus on outcomes rather than inputs will also allow for and encourage innovative approaches to delivering those outcomes. The 2010 Spending Review noted that "the use of more innovative payment mechanisms will be explored in new areas, including community health services, processing services, prisons and probation and children's centres. This builds on measures already announced to implement payment by results

in welfare to work, mental health and offender rehabilitation services”.

With particular reference to competition, further reforms which are likely to influence changes in practice and behaviour can be expected with the publication of the government’s proposals for economic growth alongside the Budget in March 2011. As a prelude, the October 2010 Local Growth White Paper set out the government’s role in empowering locally driven growth, encouraging business investment and promoting economic development. This focused specifically on the creation in the first instance of 24 local enterprise partnerships to drive sustainable economic growth and create new jobs alongside the introduction of a regional growth fund to support the creation of private sector jobs, in particular in communities currently dependent on the public sector.

In November 2010, the Chancellor of the Exchequer, George Osborne and Business Secretary, Vince Cable announced a fundamental review of what all parts of Government are doing to create the best conditions for private sector growth. Departments will be required to present Action Plans on what contribution they will make to:

- reform structural barriers across the whole economy in planning, competition, trade and investment, regulation, access to finance and corporate governance; and
- remove barriers in sectors where there are clear opportunities for growth and where Government can make a difference – construction, retail, health and life sciences, professional and business services, manufacturing, and creative industries.

A final set of reforms will impact on those involved in commissioning and procurement in particular government departments or service areas. Specifically these service-specific reforms include those set out in the January 2011 Public Health White Paper (in particular GP commissioning), the November 2010 Welfare Reform White Paper (the Work Programme), and reforms in education, including the increasing conversion of existing schools to academy status.

Taken in the round, the government’s reform agenda is bound to have a profound impact on the role and behaviour of commissioning and procurement staff at all levels of the public sector. However, in addition, those working in commissioning and procurement will also need to respond to a number of specific initiatives that set out fundamental changes to government procurement in support of the substantial fiscal retrenchment planned for the current Spending Review period.

With this in mind, a push for commissioning and procurement to secure a lower price and, at the same time, receive better quality services is at the heart of work led by the Efficiency and Reform Group. This push also underpins the government’s response to the findings of the Sir Philip Green efficiency review, published in October 2010.

Specific reforms which underpin the priority of the Efficiency and Reform Group to improve government procurement include an early focus on centralising commodity procurement for central government, renegotiating contracts with existing suppliers as part of a move towards establishing government as a single, effective customer and maximising the savings from – and assuring the viability of – major projects. For some of these reforms, such as centralised commodity procurement, practitioners are likely to need to change the ways in which they operate in line with mandation from the Efficiency and Reform Group.

The Cabinet Office minister has also announced the government’s intention to award 25% of all government contracts to small and medium enterprises<sup>6</sup>, which are seen as bringing flexible, innovative solutions and responsive to local need.

In order to help achieve this, the government is undertaking a ‘lean review’ to uncover delays in government procurement processes alongside asking the government’s major IT suppliers to work with SME’s, mutual’s and joint ventures in new contractual arrangements.

As a result, specific reforms to procurement practice, wider public service reforms and fiscal retrenchment will present a significant challenge to those working in commissioning and procurement within the public sector as they seek to change their behaviour to respond to a range of new priorities.

However, these reforms do present new opportunities and challenges for commissioners within the public sector to learn from what has already worked (or not) in similar contexts. While the government is proposing substantial reforms to the public sector, many of the proposals for reform have been trailed elsewhere in the public sector (for example, independent sector treatment centres in the NHS and private sector prison and detention centre capacity) or build upon successful reforms in other countries (for example, proposals for welfare reform build upon programmes developed in the U.S. and Australia).

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<sup>6</sup> ‘Coalition Programme for Government’ (2010)

## How government commissioning works

### Commissioning and procurement

The 2005 OFT-commissioned report, ‘Assessing the impact of public sector procurement on competition’, provides working definitions of both ‘commissioning’ and ‘procurement’:

- “Commissioning is the cycle of assessing the needs of people in an area, designing and then achieving appropriate outcomes”; and
- “Procurement is the actual purchase of goods and services by budget holders.”

This definition of commissioning captures a process that starts with policy makers making decisions about desirable outcomes and priorities; continues with commissioners who assess needs and the ability of the market to respond to them, stimulating the market if necessary; and is completed by procurement officials whose role it is to purchase the goods and/or services.

A ‘generic’ commissioning cycle is depicted in the diagram below. Decisions and behaviours at all stages of this process may impact upon the degree of competition in the supplier base.

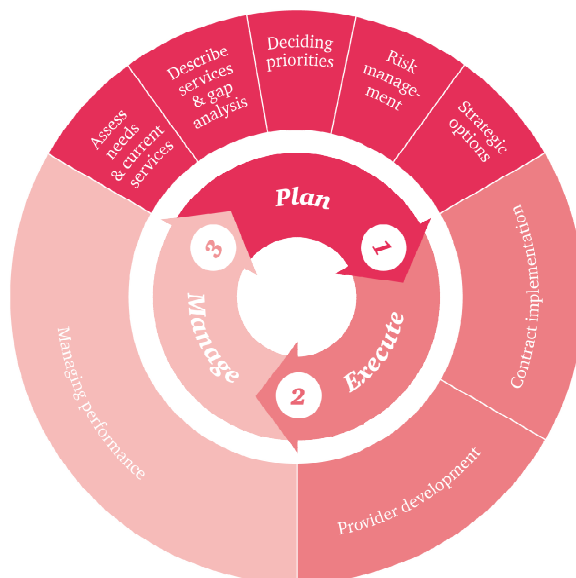


Figure 2 A generic public sector commissioning cycle<sup>8</sup>

<sup>7</sup>Assessing the impact of public sector procurement on competition, .econ (2004)

<sup>8</sup> Developed by PwC through our work on strategic commissioning across the public sector. It provides a higher level look at the commissioning lifecycle than the 15 step procurement process guidance provided by the Office for Government Commerce.

### Procurement processes

In most cases<sup>9</sup> the public sector must follow EU procurements rules<sup>10</sup> when buying goods and services (as well as EU and UK competition and EU state aid law). There are four main procurement procedures

1. **Open procedure:** Public authorities have a free choice between the open and restricted procedures. In the open procedure, at least three quotes must be sought. All suppliers may tender.
2. **Restricted Procedure:** This is a two-stage process involving: (i) selecting (shortlisting) a number of suitably experienced, qualified companies, and (ii) inviting those selected companies to submit proposals. All suppliers may express an interest before the first stage, but only the suppliers (a minimum of five) selected from those who meet the minimum requirements may tender.

The method by which the suppliers who are to be invited to tender are selected is via the use of a Pre Qualification Questionnaire (PQQ). The purpose of using a PQQ process is to enable the buying authority to create a short list of potential suppliers by obtaining sufficient information to evaluate the suitability of potential suppliers in terms of technical knowledge and experience, capability/capacity, and organisational and financial standing.

In February 2011, the Prime Minister announced plans to eliminate PQQs for all central government procurements under £100,000, leaving procurers free to choose the best route to market for their individual circumstances.

3. **Negotiated Procedure:** This can take two forms (either with or without a call for competition, though the latter is far less common) but can only be used in exceptional circumstances. Again, the negotiated procedure with a call for competition is a two stage process, with the first stage involving short-listing (done on the basis of a supplier’s capacity to meet the client’s minimum requirements for economic and financial standing and technical capability, rather than how it proposes to meet the contract) and the second involving entering into negotiations with the suppliers with a view to agreeing on the terms of a contract. In a negotiated procedure, only those suppliers (a minimum of three) selected from

<sup>9</sup> Depending on the subject matter of the procurement and scale thresholds

<sup>10</sup> Set out in Public Contracts Regulations 2006 for England, Wales and Northern Ireland and the Public Contracts (Scotland) Regulations 2006 for Scotland

those who meet the client's minimum requirements may tender: a client may negotiate the terms of the contract with these suppliers.

4. **Competitive Dialogue:** The competitive dialogue procedure is available where the contract cannot be awarded under open or restricted procedures.

Like the restricted and negotiated procedures, this is a two-stage process. The first stage ("the dialogue") allows for discussion between the invited tenderers (a minimum of three) and the Contracting Authority. At the end of the dialogue phase tenderers are invited to submit proposals which will not then be subject to further negotiation. This procedure is for "particularly complex" procurements and can only be used in exceptional circumstances where it would not be possible to award a contract using the open or restricted procedures and where circumstances do not permit use of negotiated procedures.

Competitive dialogue can be used to help define the means of achieving broad objectives and may embrace all aspects of the contract for the purpose of identifying one or more solutions which meet the purchaser's needs before seeking bids from those remaining in the dialogue. It always involves competitive tender and can only use the "most economically advantageous" (MEAT) award criterion.

Under the restricted and negotiated procedures or competitive dialogue, there must be a sufficient number of participants selected to proceed to the tender stage to ensure genuine competition. The Regulations require a minimum of five for the restricted procedure, and three for competitive dialogue and negotiated procedures, where there are sufficient qualified candidates.

## Commissioning and competition

When conducting commissioning and procurement exercises, public sector organisations' objectives can be thought of as having two dimensions:

- Time horizon: the public sector aims to achieve value for money over both the short and long-term. Value for money takes account of both price and the different elements of value; and
- Scope of interest: it also seeks value for the procuring body, other buyers in the public sector and the economy as a whole.

Public sector buyers may have longer-term and broader objectives than many of their private sector counterparts.

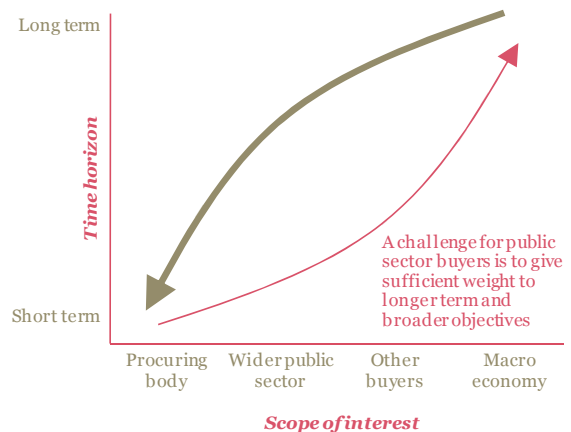


Figure 3 The public sector's commissioning objectives

In perfectly competitive markets (i.e. where the buyer takes the price determined by the market, typically for a commodity), the market will determine an efficient solution.

However, in practice, the public sector often buys from markets which are not close to being perfectly competitive. Indeed, much of the rationale for the existence in public sector involvement is that there are market failures that mean the market by itself will not deliver the desired outcome. For example, it is unclear there would be a market for welfare provision if this was not commissioned by government.

In the presence of market failure, tensions arise between the different objectives set out in Figure 1, and public sector buyers must (explicitly or implicitly) decide on their relative importance.

Taken collectively, the public sector possesses significant buyer power in many of the markets in which it operates, leaving it in a potentially powerful position to affect markets and to either correct or exacerbate market failures.

A more in-depth discussion of these issues can be found in the literature review in Appendix 1.

## Comparing public and private sector commissioning

The private sector is not required to follow the EU law that governs public sector procurement, so has a freer hand in how procurement is conducted. The UK Public Contracts Regulations stipulate the various procedures and timescale and the principles of transparency, non-discrimination and equal treatment that apply to procurements where public money is used, which do not apply in the private sector. If the Regulations are not followed then there is a significant risk of legal challenge.

Many suppliers separate the sales force into those serving the public and those serving the private sector. The reason for doing so is not just because the different sectors often require different blends of goods and services, but the skills required to succeed in a public sector procurement competition differ from those required to win in the private sector. In the public sector, success is determined by the ability to follow process, the ability to script a successful bid and the ability to pitch well. The private sector sales process usually requires all of the above plus the ability to engage effectively with stakeholders before and during the process.

Procurement experts we spoke to indicated that while public sector procurement processes can, if well planned and executed, amount to good practice. However it is often more bureaucratic and slow and poor execution more often results in sub-optimal outcomes compared to good private sector procurement.

*“Public sector procurement processes aren’t far off good practice, so they are close to the way the private sector tends to make big sourcing decisions. However, the public sector does have a bit of a one-size-fits-all approach which is overly bureaucratic when it comes to smaller buying decisions” – Procurement Expert*

PwC has supported many private sector organisations in procurement activity and we find, in contrast to the public sector:

- Individual decision-makers have more autonomy. Within delegated financial limits and risk tolerances, they have a lot more discretion to determine how to conduct procurement activity than their public sector counterparts. Private sector buyers may have a greater ability to consider ‘softer’ criteria, such as relationships with potential suppliers, when considering procurement decisions<sup>11</sup>;
- The greater flexibility often means much shorter and less bureaucratic process is followed, for example with three bids being invited and considered less formally than in a typical public sector exercise for small value open procedure procurements. The tender process is more likely to be proportionate to the value of the goods being bought and reflects the size and ability of

likely market participants to participate in these processes;

- For larger procurements, private sector organisations tend to invest more energy in following good practice. This is mainly to achieve good value for money, but also to minimise the risk of challenge. This often leads them to follow a similar process to that which would be used in the public sector. There may be some simplifications, for example around waiting times and the amount of documentation and paperwork required, but the main steps in choosing a supplier are often the same;
- Key stages in a large private sector procurement that follows good practice might be: data and market analysis determine business requirements, develop category strategy, supplier selection and negotiation, implementation, supplier and contract management. Private sector procurers are likely to dedicate more time to market analysis and to understanding the data available to them. In the public sector there can be a lack of preparation, planning and market engagement; and
- Procurement is generally considered to be important in the private sector, with accompanying recognition of it as a skilled profession and greater investment in capacity and capability than is usually the case in the public sector.

In general, the differences between private and public sector procurement processes are perhaps smaller than one might expect, but those differences that do exist can have a significant impact on competition by creating barriers to entry in models to supply the public sector. Some of these differences result from the requirements to follow procurement directives and regulations, but others may result from cultural differences such as the way procurement is perceived, the presence of more layers of management slowing down the process and pockets of risk aversion in the public sector.

While public sector procurement rules are intended to guarantee a minimum level of transparency, rigour, accountability and competitive tendering, these are all standards that best practice private sector procurement also aspires to.

The degree of effective interaction with suppliers can also vary between the public and private sectors. The procurement Regulations that apply to public sector authorities require then to advertise procurement opportunities in the Official Journal of the European

<sup>11</sup> It is possible for public sector procurers to allow for softer criteria if this is required but there is a significant difference in the degree to which the public sector is required to be very explicit, transparent from an early stage as to what the evaluation criteria are and how they will be measured and weighted.

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Union, which any supplier can access, thereby informing a wide range of potential suppliers.

It is also possible for public procurement authorities to undertake market consultations prior to (and even after the start of) a procurement in order to test the attractiveness of its proposition or the validity of its assumptions or requirements.

However, the belief by some authorities that they need to treat all prospective suppliers “identically” in order to fulfil the general requirement of “equal treatment” can result in poor, or cumbersome, interactions with suppliers which can result in less effective market testing and development of procurement specifications. This, in some cases, can limit the ability of suppliers to provide innovative solutions.

Recent reviews have suggested that contract management in the public sector is often poorly carried out. Where there is a limited capacity or capability to undertake this important task then it is unlikely that the potential value of the contract with the supplier will be realised. The public sector is often more reluctant to take a hard line in contract enforcement including terminating contracts, even where this may be a contractual right.

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## *C. Commissioning and procurement behaviour*

## Commissioning and procurement behaviour

Our research consisted of a survey of people involved in public sector commissioning and procurement, a series of in-depth case studies and a literature review. The results from the survey are presented below, whilst the case studies are detailed in subsequent chapters.

We conducted a set of short interviews with 30 commissioners, procurers, suppliers and regulators<sup>12</sup>. While this survey was not intended to achieve statistical significance, it did allow us to explore the drivers of behaviour across the wider public sector commissioning and procurement landscape. The questionnaire used for interviews can be found in appendix 2.

Our research has identified a number of key drivers of commissioning behaviour and the eventual outcomes of public sector commissioning. These are depicted in the framework set out in Figure 1 and discussed in the paragraphs that follow.

There are two important points to bear in mind when considering the framework.

First, as the diagram notes, these behavioural drivers operate at different levels:

- skills and incentives at an individual level;
- objectives, rules and organisational boundaries at an organisational level;
- Market engagement and wider issues involve actors external to the commissioning organisation.

Being conscious of these distinctions is helpful in understanding the impact of these drivers and identifying the appropriate levers to affect them.

Second, as well as operating at different levels, these drivers also impact at different stages of the commissioning cycle. Commissioners always start within a given context – fiscal constraints, new policy directives, changing priorities, etc. Commissioners possessing the appropriate skills and incentives will dictate whether that wider context translates into appropriate, well thought out commissioning objectives. Public sector procurement rules and the appropriate organisational design (allowing procurers to gain a sufficiently complete understanding of the policy objectives), will in turn dictate how successful

the market engagement strategy is in helping achieve those objectives. This is an ongoing, iterative process.

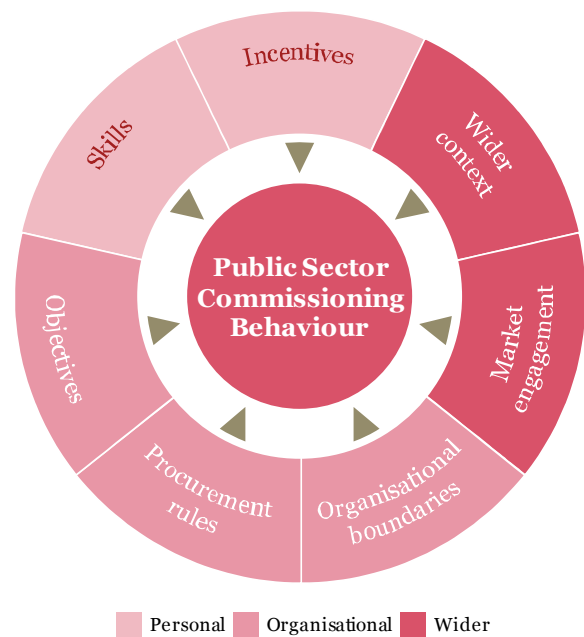


Figure 4 Drivers of public sector commissioning behaviour

## Incentives

The appropriate alignment of incentives for the various agents involved in the commissioning/procurement process is an essential ingredient in generating beneficial outcomes. This applies from the initial conception of the policy, to the commissioning of services to support that policy, to the design and management of procurement contracts. The extent to which the various incentives of individual agents are aligned or not (for example, through mechanisms such as performance management and governance controls) will have a crucial influence on whether the competitive framework in practice will be close to the one that is sought. Incentives for public sector employees are often not financially structured; they may be more related to improving promotion prospects by delivering big deals (rather than focussing on longer-term contract management).

The comments from interviewees suggest that many of these incentives are tacitly, rather than explicitly designed, with a typical view summarised by one respondent:

*“If they are procurement specialists they should be motivated to do what is best for their organisation. It is an integrity issue.” - Regulator*

The reasons for particular types of commissioning behaviour are often closely related to the incentives of commissioners and procurement specialists. It is a very common view that the vast majority of those

<sup>12</sup> Regulators of public sector activities.

involved in public sector commissioning have a strong public service ethic and their overwhelming concern is value for money for the taxpayer. However, other more personal factors are bound to be of some importance, such as other business objectives (for example, delivery deadlines) and organisational culture (for example, including risk aversion).

*“Compliance with the rules we operate to is the major incentive” - Procurer*

## Skills

The level of commissioners’ and procurers’ skills is also an important driver of the way in which they fulfil their remit. They may have a particular impact on the design of contracts, negotiations with suppliers, and the on-going relationship between commissioners and suppliers.

55 per cent of respondents reported that commissioners and procurers had an understanding of how their decisions impacted on the market. Figure 5, below, illustrates a strong difference in perception of commissioning and procuring skills. **85 per cent of procurers reported feeling that they understand the impact of their decisions; the vast majority of suppliers (89 per cent) disagreed.**

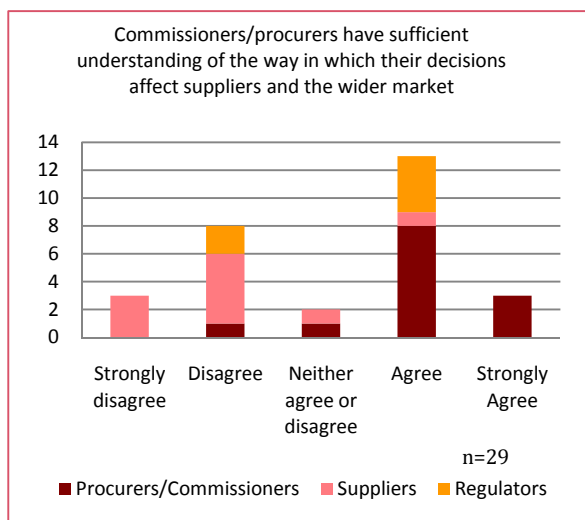


Figure 5 Mixed views on the skills of public sector procurers and commissioners

*Public procurement has to use the experts, who should have a full understanding of the impact of their decisions on the market place.” - Procurer*

*“They have no understanding of the costs associated with procurement.” - Supplier*

*“Buyers do not appreciate the time and expense required to reply to IITs.” - Supplier*

While some suppliers attributed the perceived focus on price (described below) as a result of the current fiscal environment, others linked it to a lack of skills:

*“Buyers do not understand the products well enough to make informed decisions on or judgements with regards to quality; therefore the focus is inevitably on price.” - Supplier*

*“Often the procurers do not have enough expertise to judge which offerings will provide the best package for the client.” - Supplier*

## Objectives

The importance of objectives varies at different points in the commissioning cycle, resulting in a number of trade-offs. **There may be, for example, a tension between a short-term focus on price and quality and a desire to ensure a healthy competitive landscape in the longer-term.** Moreover, the objectives of different agents involved in the commissioning process may – and often do - vary. The presence of such potentially contradictory objectives may undermine the overall coherence of a commissioning process, and, with that, any strategies to encourage competition through the process.

We asked interviewees to rate on a scale of importance various different factors which public sector organisations prioritise during the commissioning and procurement process, including price, quality, value for money and impact on suppliers. The majority of respondents rated price highly, with suppliers rating it as the most important objective:

*“There has been a clear shift in the past 12 months, with an increased focus on price” - Supplier*

Regulators and procurers rated quality more highly than suppliers, who felt it was a less important driver of procurement decisions. In keeping with OGC guidelines, value for money was rated as the most important objective by regulator and procurers. However suppliers appear to believe that the balance has shifted significantly towards the ‘cost’ side of this equation:

*“Procurers are now focussed on getting the best design possible for the lowest cost. It used to be getting the best design for VFM, but now the cheapest price wins.” - Supplier*

**Two thirds of respondents felt that the impact of procurement decisions on suppliers was given low level importance.** This was particularly the view of suppliers, while procurers were more mixed in their views, with 38% ranking ‘impact on suppliers’ as a ‘4’ (out of 5), 46% ranked it as a 1 or 2.

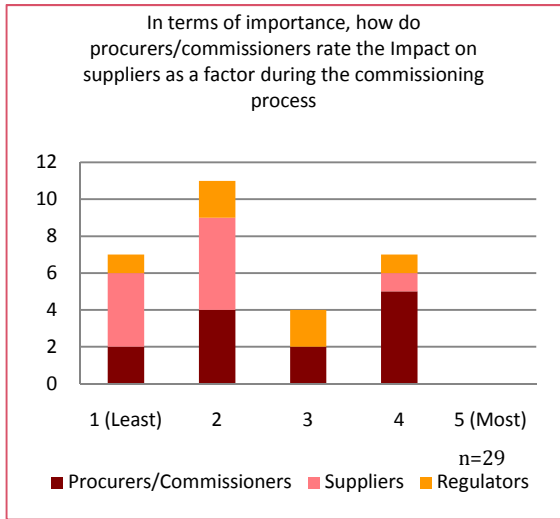


Figure 6 The impact on suppliers is not seen as important in the decision making process

## Procurement rules

59% of respondents felt that procurement rules are a constraint for buyers and suppliers, though this was a more widespread view among suppliers than procurers. However, **64% of respondents felt that public sector culture was a constraint on the commissioning and procurement process.**

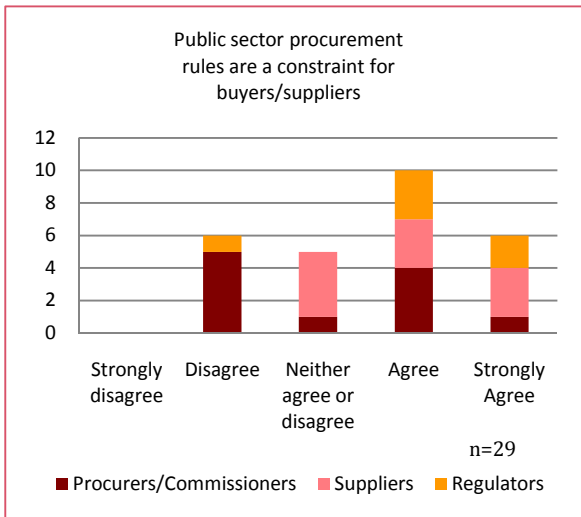


Figure 7 Public procurement rules are a constraint for buyers and sellers

*“You need to know the rules of the game when you supply to the public sector - this requires time to be successful. If you understand the rules then they are not a constraint.” - Procurer*

*“We can no longer negotiate with suppliers.” - Procurer*

*“The system is probably as fair as it can be for larger suppliers. However, it is more difficult for smaller suppliers due to the costs involved in getting on frameworks.” - Supplier*

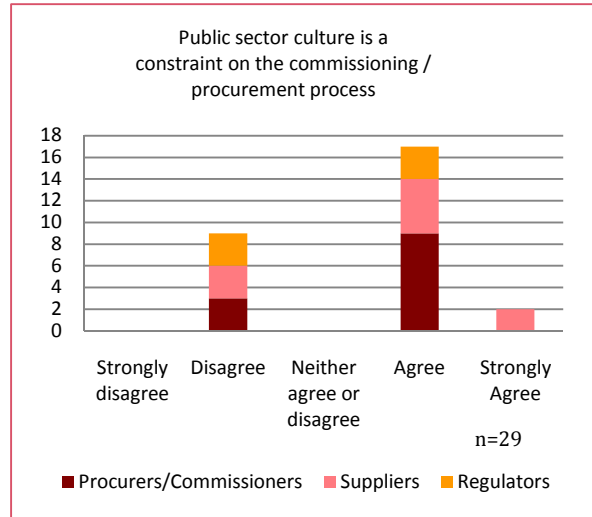


Figure 8 Public sector culture is a constraint on the procurement process

*“A lot of people don't understand the process e.g. they want things done tomorrow. It is a hindrance but it keeps them legal.” - Procurer*

*“The amount of red tape causes difficulties for buyers and suppliers.” - Regulator*

The current combination of rules and culture are also not seen as promoting efficiency or innovation. Buyers and suppliers have very different perceptions of these issues.

90% of suppliers and the majority of regulators shared this view. In contrast 75% of procurers and commissioners felt that the current practices were a source of increased efficiency in the market.

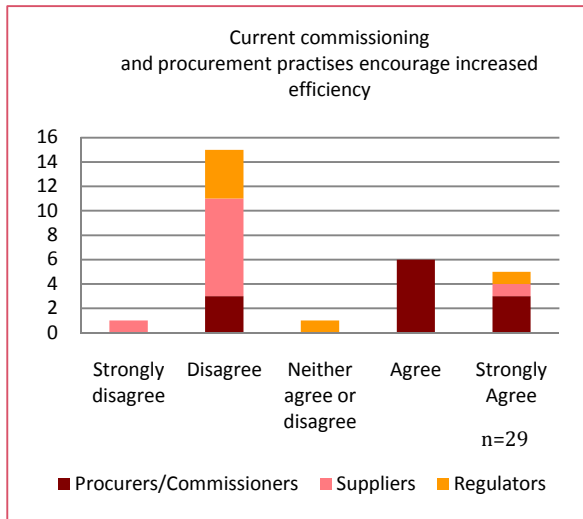


Figure 9 Current processes do not encourage efficiency

*“Rules are so bureaucratic they don't encourage efficiency.” - Procurer*

*“The process not geared up for efficiency. Suppliers need to be good at playing the game.”- Supplier*

*“Suppliers in the market are now providing more than was required in order to try to win work. Is this efficiency?” – Supplier*

This is seen as having a knock-on effect on incentivising innovation, with 50% of respondents suggesting that the current processes did not encourage innovation.

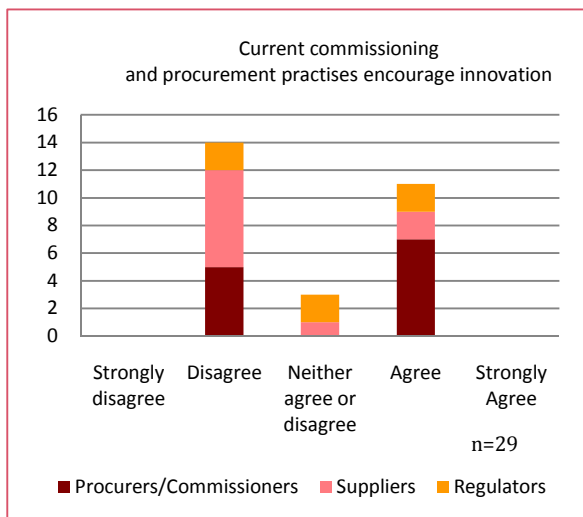


Figure 10 Current practices do not encourage innovation

*“Public sector is very risk averse and therefore there is a reluctance to go for new solutions.” - Procurer*

Overall, views about public sector rules and culture amount to a picture where **two thirds of**

**respondents agreed that there are significant barriers to entry into public sector markets.**

The percentages for each of the groups reflected the overall average with 75% of procurers, 60% of suppliers and 67% of regulators sharing this view.

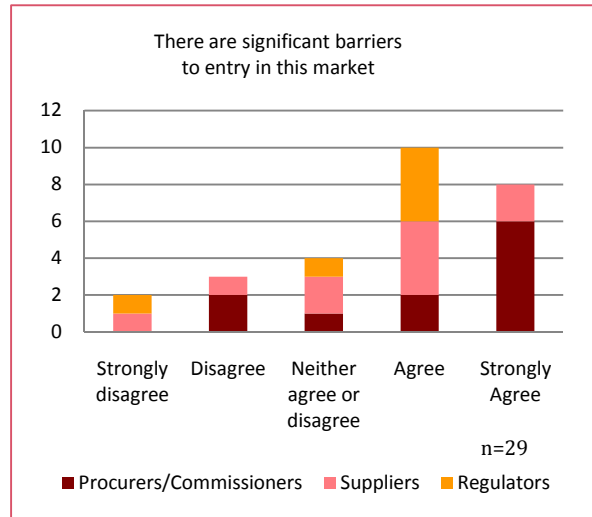


Figure 11 There are significant barriers to entry

*“PQQs are difficult for SMEs. The move to a standard annual PQQ will make things easier for smaller firms.” - Procurer*

*“Administrative and financial requirements make it very expensive to win public sector contracts, which works against smaller firms.” Supplier*

*“There is a drive to get the bigger companies to use SMEs as sub contractors on the bigger jobs.” - Regulator*

## Organisational boundaries

Organisational boundaries are an issue that emerged strongly during the course of our research, with respondents keenly aware of the different roles played by policy makers, commissioners and procurers, and the frustration that can arise when those three groups are not sufficiently joined up.

Those boundaries can result in policy makers and commissioners failing to take sufficient account of the current state of the market and in mixed messages being communicated to suppliers, some of whom **reported perceiving procurement officials as a stage to get past in the bidding process before reaching those who understand the specific requirements of the services being procured.**

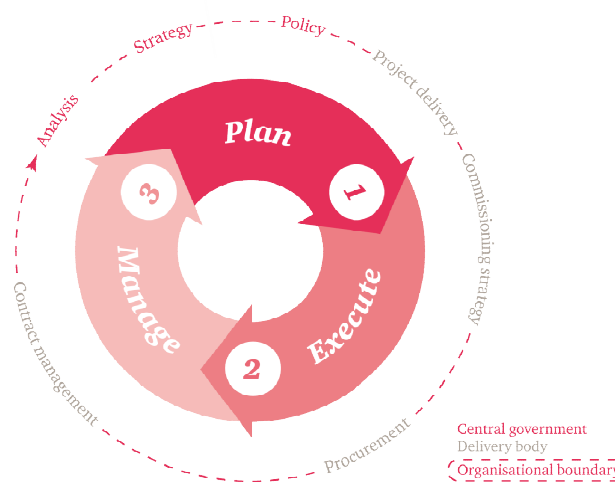


Figure 12 Organisational boundaries over the commissioning cycle in a complex procurement

## Market engagement

**83% of procurers believed they send clear signals to the market**, but 50% of suppliers and 50% of regulators disagreed.

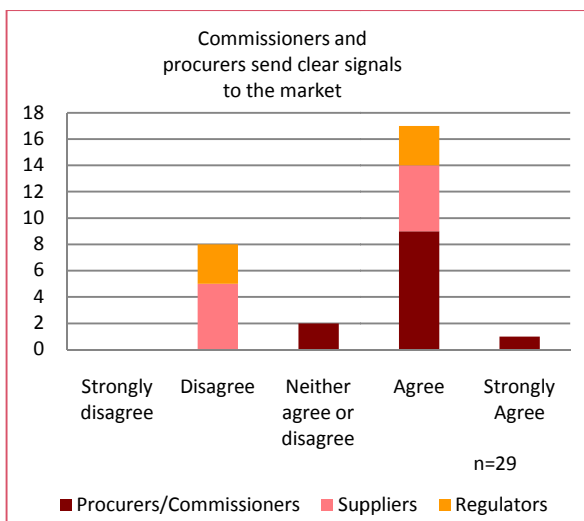


Figure 13 Clear signals are sent to the market

*“The signals are as clear as they can be in the political environment we work in.” - Procurer*

*“We usually give clear signals, but sometimes this is not the case.” - Procurer*

The provision of, and access to, information is important. More information allows commissioners and suppliers to make better informed decisions. In particular, there is the need for commissioners to have access to information on the demand-side, for example on the requirements of the end user, and on the supply-side, for example on the ability of different suppliers to provide those services. Information on

suppliers may include price, volume, market size, market growth, range and quality of services. Equally, access for suppliers to information on the intentions, needs and budgets of the commissioner are essential in determining short and long-term market participation and the nature of proposals submitted.

Two thirds of respondents agreed that commissioners and procurers have enough information to make informed decisions, although 40% of suppliers disagreed.

A number of survey respondents agreed with the comments of one interviewee that commissioners and procurers are “conscious of not wanting to put unnecessary burdens on suppliers” in relation to requesting information. However, further probing suggested that, **while a majority think that more information would help make better decisions, knowing what to ask for and how to use it is more important than sheer quantity:**

*“Having more expertise rather than information would help them to make better decision” - Supplier*

*“The information is only good if you know what to ask for” - Procurer*

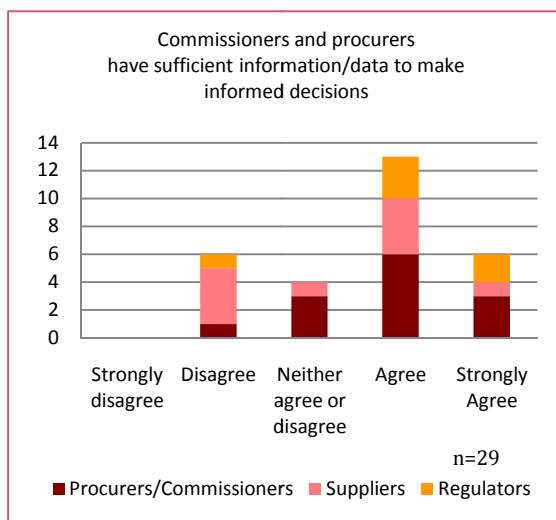


Figure 14 Commissioners have enough information to make decisions

*“We should have all the information we require. At the pre-tender stage we should know all the information we require to make the right decisions. We should be ‘Intelligent Buyers.’ - Procurer*

The structure of, and engagement with, the market is relevant in a number of important respects. The definition of the relevant market (in terms of the service provided, geographical region, scope for substitution, and its size, dynamics and growth patterns) is central to understanding both the extent of buyer power afforded to commissioners and

procurers and the level of competition in the market more generally. In some services the public sector may be the only source of demand, whilst in other services suppliers may be subject to demand from both the private and public sectors.

Additionally, whilst commissioning may be used to meet an already existing and well-defined public demand, commissioning and procurement behaviour may also influence the development of an emerging market if, for example, a commissioner decides that services should be provided in one specific way rather than another. Such decisions may also have an impact on the level of competition.

**While there was a perception that impact on suppliers is not high on the list of considerations during the procurement process, there was widespread agreement that public sector procurement has a significant impact on suppliers and the marketplace.** This suggests a need to make sure that the range of objectives and incentives are adequately and systematically aligned.

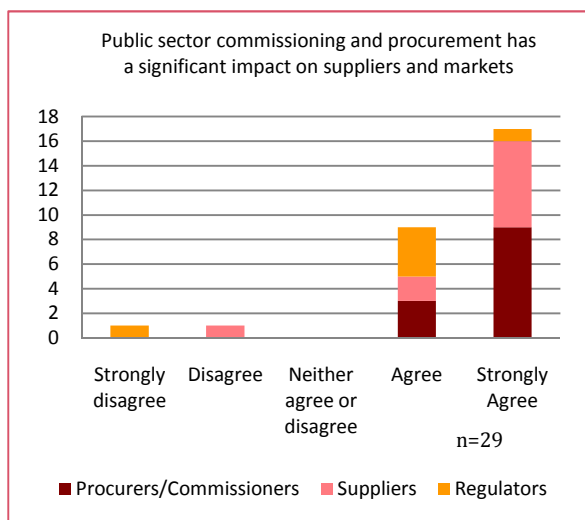


Figure 15 Public sector procurement has a significant impact on suppliers and the marketplace.

Sending the right signals to the market is a crucial ingredient of successful market shaping and engagement, allowing suppliers to plan appropriately to meet public sector needs. This is an area where commissioners/procurers have a very different assessment of current practices than suppliers.

**85% of procurers indicated that there were sufficient levels of engagement, but 40% of suppliers and 65% of regulators disagreed.**

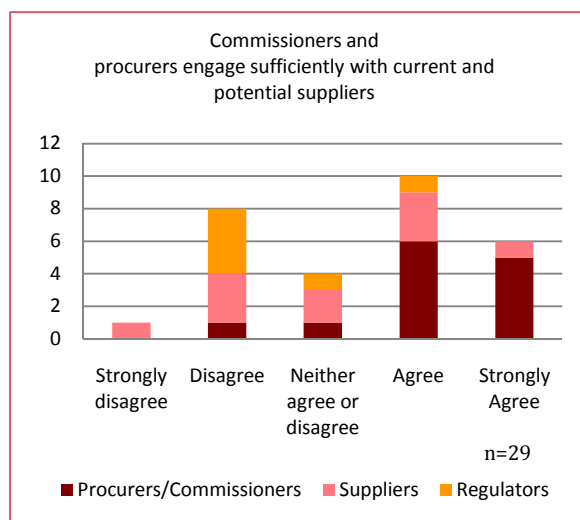


Figure 16 There is room to improve engagement with suppliers

These figures may reflect strong perceptions among commissioners about the requirement to be transparent and fair. This impacts on the levels and type of engagement that public sector commissioners and procurers feel able to engage in.

*“We need to be squeaky clean with our relationships with suppliers. The engagement with them is structured and formal.” - Procurer*

*“They need to be careful to treat everyone equally.” - Regulator*

*“There is now less one to one engagement. It is carried out via industry days rather than individual contacts.” - Supplier*

This last point arose a number of times in both survey and case study interviews, and was not universally welcomed as a development. While for commissioners industry days provide a chance to engage with large numbers of suppliers in a manner that is seen to be impartial, suppliers also value one-to-one conversations and relationships and can be reluctant to talk frankly in front of competitors for fear of giving away commercially advantageous insights to competitors. Suppliers of residential care homes reported that the best commissioners to work with were those who sustained relationships and engaged with suppliers. Likewise sub-contracted welfare to work organisations regretted the loss of their close relationships with DWP officials – partly as it represented a loss of influence, but partly because it was a valuable source of information about policy directions and how their organisation might be affected. Fear of giving away commercial insights in a public setting was expressed by suppliers in the FND and prisons case studies.

## Wider Issues

Wider issues, in particular the political and economic context, are likely to have a powerful impact on commissioners' and procurers' priorities.

Perhaps unsurprisingly, the economy is reported as having a very large impact currently.

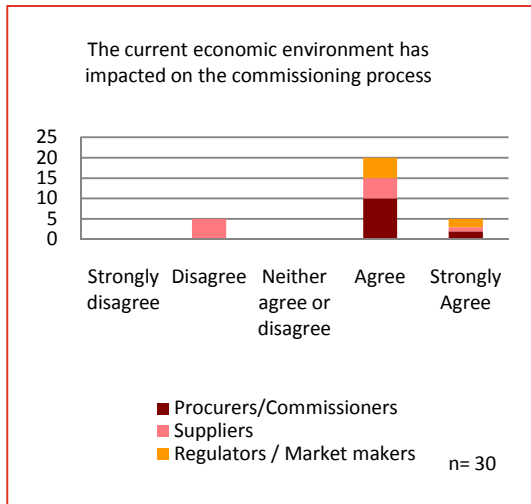


Figure 17 The economic environment has had a significant impact

Current government priorities, such as localism and Big Society, are also having an impact.

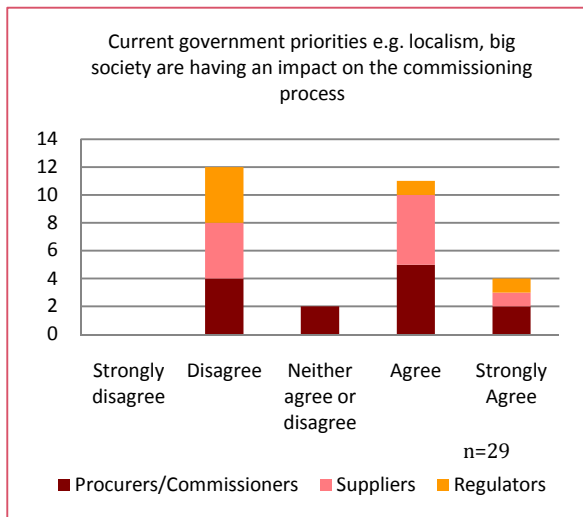


Figure 18 Current priorities are having impact

*"We follow Scottish Government priorities for Sustainable Economic Growth."* - Procurer

*"There is a move to go for more local suppliers."* - Procurer

*"There is a drive to get more SMEs working in the building market. Therefore, you need to include SMEs in the consortia for your bid."* - Supplier

79% of respondents felt that there is a tension between trying to achieve greater localism and economies of scale.

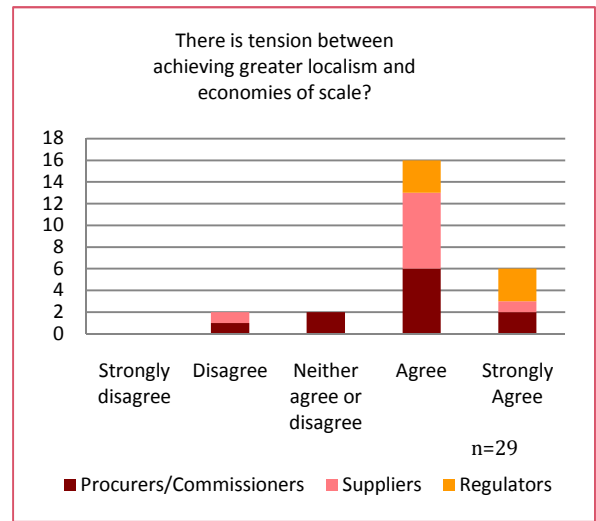


Figure 19 Tension exists between localism and economies of scale

*"There is a conflict because purchasers are looking for VFM, while the people who commission the work want to use the people they know on the ground."* - Procurer

*"Devolution has gone too far in certain areas, with some local authorities only using Scottish suppliers."* - Regulator

## Conclusion

The mini-survey provided evidence that the behavioural drivers summarized in figure 4 are key to understanding public sector commissioning behaviour.

There were some particularly striking differences of perception from suppliers and commissioners/procurers, in particular regarding objectives (value for money versus price) and whether sufficient market engagement takes place.

The central conclusion is that, while an overwhelming majority agreed that public sector commissioning and procurement has a significant impact on suppliers and the market, most respondents felt that this did not feature high among the objectives of commissioners and procurers.

The following chapter summarises a series of case studies, which explore these issues in greater depth.

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## *D. Case studies*

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## Introduction

The purpose of this case study analysis is to gain a better understanding of the drivers of commissioning and procurement behaviour in the public sector and their role in influencing market outcomes.

The case studies, which were chosen in consultation with the OFT, have been selected on the basis of their relevance to current themes in commissioning and procurement. The case studies would:

- Be relevant to important, topical themes in government commissioning and competition, for example, the opening up of markets that have traditionally been self-supply and the development of new markets;
- Achieve a high degree of relevance to big current areas of reform and commissioning in government, such as welfare to work and GP commissioning, whilst achieving a reasonable coverage of different parts of the public sector; and
- Build on solid foundations in theory and literature by achieving a reasonable spread across important dimensions of commissioning and competition, such as scale of the market and the procurement, ease of measuring quality and method of procurement.

These case studies feed into the OFT's own report on commissioning and competition in the public sector. This report identifies practical insights that can be used by public sector commissioners and procurers in local, devolved and central government on how best to promote and sustain effective competition. In turn, this will help to create dynamic, open and contestable markets for public services in which commissioners, procurers and suppliers alike face appropriate, aligned incentives to achieve and sustain value for money.

### *Case studies chosen*

1. Prisons
2. Adult residential care home places
3. School supplies
4. Administration services for NEST
5. Hospital facilities management
6. Flexible New Deal
7. International welfare to work experience

We also examined international welfare to work markets as a comparator to the final case study.

For each case study, we held a number of background discussions with experts and then interviewed six to eight of the key people involved. Interviewees included buyers, sellers and, in some instances, other key stakeholders. By way of comparison, the survey focussed on similar categories of individuals from across the public sector, without focusing explicitly on the case study areas.

This chapter sets out summaries of our findings with respect to each case study.

These summaries are intended to bring out the most salient findings and lessons relevant to this study rather than full accounts of complex procurements. Whilst the summaries reflect the accumulated views of interviewees, they do not necessarily reflect the views of any one individual or any of the organisations involved.

# Case Study 1

## Prisons

### Key findings

1. Commissioning from the private sector has helped drive efficiencies in all prisons while simultaneously helping grow a competitive supply base.
2. Private sector penetration in the provision of public sector prisons remains relatively low, resulting in a relatively small number of suppliers, though the specialist nature of the service also contributes to a small supply side.
3. Suppliers have sometimes felt that government has sent mixed messages over their role in the provision of prisons. This has been due to a number of factors including changes in government policy which have resulted in changes in the estimate of future prisons population and the *threat* of going to market used to drive better performance in public sector run prisons.
4. The bundling of 'Design, Construct, Manage and Finance' (DCMF) into one contract attracts private sector investment and reduces the number of contracts to manage. It may also incentivise those designing and building the facility to ensure it is easy to maintain and supports the desired operating model. However, it can also reduce the number of potential bidders and the degree of flexibility in the operation of the contract.
5. In the past there have been level playing field concerns due to workforce regulations and access to information.

### Market overview

#### What was bought?

New prison facilities and/or prison management services.

#### Who bought the services?

National Offenders Management Service (NOMS), an agency of the Ministry of Justice (MOJ), responsible for commissioning and delivering adult offender management services, in custody and in the community, in England and Wales.

#### Who provide the services?

Large private sector government services companies, often in partnership with construction companies and third sector organisations.

#### Size of purchase

Large – eleven prisons are currently managed by the private sector. 25-year service contracts each have a value running into hundreds of millions of pounds.

#### Size of market

The number of suppliers is small – there are three private sector companies managing prisons, although there are seven consortia on the hitherto unused 5-prisons framework.

#### Procurement process

Negotiated procedure; competitive dialogue; framework agreement.

### Background

The private sector's involvement in the provision of prisons—initially limited to the provision of services to new prisons holding unsentenced prisoners—dates back to the Criminal Justice Act 1991. Two amendments to the Act sought to expand the role of the private sector:

- The Criminal Justice Act 1991 (Contracted Out Prisons) Order 1992 extended contracting to the management of sentenced prisoners; and
- The Criminal Justice Act 1991 (Contracted Out Prisons) Order 1993 extended contracting out of existing prisons.

Whilst the first amendment resulted in 11 private sector managed prisons today only one in nine prisons is managed by the private sector. There is yet to be a single case of a public sector built and operated prison being taken over by the private sector.

The first four private sector contracts were 'management only'. The second set was driven by Private Finance Initiatives (PFIs) across nine Design, Construct, Manage and Finance (DCMF) 25-year contracts. By including full custodial services, these contracts are examples of a more complete construction and service agreement than examples in most other sectors, where the core functions are not normally part of the PFI contract. School PFIs, for example, include only the maintenance of the building, not teaching; and hospital PFIs do not include the provision of doctors and nurses. Approximately two-thirds of the costs of a PFI prison relate to operations and one-third relates to construction costs.

A Competitive Dialogue process involving six private sector bidders began in August 2007 for the procurement of two new build prisons, Belmarsh West and Maghull. The same organisation was announced as preferred bidder for each of these contracts in June 2009, with the Belmarsh contract signed in June 2010. The Maghull project was cancelled in December 2010 due to a change in government policy, resulting in a revision of estimated future demand.

Under the NOMS New Prison Programme, published in April 2009, the ambition was to create 7,500 places in five new 1,500-place prisons. A four-year Framework Agreement was set up in the same year for the Design, Construction, Management and Finance of five prisons, with contracts ranging between 20 and 40 years. Seven private sector suppliers were selected for inclusion, with contract awards proceeding from a 'mini competition'. The framework has yet to result in the award of a contract, since the programme was put on hold by the new government.

## Current policy context

The MOJ Structural Reform Plan (SRP), published in July 2010, includes plans to reform sentencing and penalties and to 'establish an offender management system that harnesses the innovation of the private and voluntary sectors, including options for using payment by results, to cut reoffending'.

The SRP also committed to 'review the prison estate's contribution to rehabilitation and reducing reoffending, developing a sustainable and cost-effective prison capacity strategy'.

In October 2010 the coalition government announced plans to reduce the prison population by 3,000 by 2015 and to halve the £2.4bn prison building and maintenance programme.

NOMS officials we spoke to expect the private sector market share to continue to grow in future years as lower targets for the future prison population result in prison closures, with the MOJ to consider tendering for the building of new capacity to replace inefficient and worn-out prisons.

## Findings

### Objectives and entry

In the past, commissioning strategies were designed using a (DCMF) model. Introducing private capital to fund new projects was a central objective of private sector involvement.

Respondents reported that designing the commissioning strategy this way has created a barrier to entry, reducing the number of potential bidders to

those with established relationships between large construction firms and those who could bid to manage prisons.

However, NOMS's future commissioning strategy is expected to move away from this model, seeking to unbundle the separate elements. This shift reflects a number of perceived benefits from unbundling.

- First, the dramatic increase in the margins of bank or bond finance since the onset of the financial crisis means that it is significantly cheaper to borrow directly from HM Treasury.<sup>13</sup> Bank or bond funding has always been more expensive than government borrowing, but the advantages of borrowing from banks (due diligence and risk transfer) have usually been seen to outweigh the extra cost. The increased cost of private sector borrowing from is putting that balance of benefits under renewed scrutiny, although private borrowing costs are likely to come down again in future years as banks re-enter the market.
- Second, the introduction of payment by results may make the financing more expensive if the repayments are linked to the risk of operating revenue.
- Finally, shifting political priorities highlight the benefit of retaining greater service flexibility<sup>14</sup>, something which it is easier to do if the operate contract is kept separate, with banks reluctant to allow a change of operator in a PFI prison. This point is strengthened by the view held by some interviewees that while design and build are fairly commoditised services and clearly understood, ideas about the best delivery models are always developing.

Some interviewees argued that PFI does offer a level of flexibility that has not always been recognised or taken advantage of. For example, payment by results can be incorporated into new and existing PFI contracts so long as they are structured in such a way that the risk levels in the PFI contract are left unaltered. PwC is working with the New Zealand government to trial new approaches to using payment by results in a new full custodial service PFI prison contract at Wiri, the first private sector prison in New Zealand

Furthermore, it was argued by some interviewees that there can be cost advantages from combining the 'operate' and 'build' contracts, with some of the

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<sup>14</sup> For example, the desire to introduce a wider diversity of suppliers from the third sector and to use their expertise in the rehabilitation of prisoners.

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efficiencies from PFI procurements coming from new designs leading to more efficient working practices.

### **Rules, incentives, skills and organisational boundaries**

A number of questions were raised by interviewees about the procurement process.

There was some concern raised about the responsibility tightly specified tenders leave in the hands of procurement professionals as the MOJ moves away from Competitive Dialogue. While government experience of building new prisons with the private sector means that requirements are now better understood than in the past, it was not felt by suppliers that this expertise necessarily lies in the hands of procurement professionals.

Suppliers mentioned the high turnover of procurement staff, with the result that lessons and expertise are not carried over from one procurement exercise to the next. Furthermore, the perception among suppliers is that large scale procurement exercises provide opportunities for promotion for those involved, with a resulting tendency of those running the procurement to focus on delivering the contract on time and within budget, to the potential detriment of other longer-term concerns.

Questions were also raised about whether the right people have always been involved at the right time in the commissioning and procurement processes. Over time there has been a shift towards more of an evaluation role in procurement, away from a focus solely on technical details. But the perception among suppliers is that junior procurement officials have remained too separate from both the commissioners and the operational experts while drawing up and evaluating contracts<sup>15</sup>. Bid documents are also carved up among several procurement officials, with one provider arguing that this makes it difficult for those concerned to take a sufficiently expert and holistic view of what the bid is proposing to provide. It was also argued by suppliers that this can give rise to a risk of the prisons being treated in evaluations as more standardised commodities than they in fact are, as service design will have an impact on a prison's design requirements and should thus be seen as part of a whole.

This picture can result in situations where suppliers complete bid documents with one eye on passing through the procurement process and another on what they understand the commissioners to be looking for, without those two things necessarily being perceived as one and the same.

While it is recognised that competitive dialogue can be lengthy and expensive compared with using a framework agreement, it was seen by suppliers as having the advantage that it avoids a move towards more standardised requirements which could come at the expense of innovative solutions, leaving competition to be driven more by price than quality.

It was reported that NOMS has made welcome efforts to improve its organisation recently, with meetings between policy makers, commissioners and procurers, and efforts to leave procurement officials less isolated from the wider process and expertise.

### **Market engagement**

NOMS has in the past signalled its desire to see a clear and vibrant market, both for the DCMF and operational contracts. However, suppliers feel that there have at times been mixed signals and insufficient detail about what market share the government is aiming for the private sector to control and over what period of time, making it difficult for suppliers to plan. This is especially important in a market in which the public sector plays such a prominent role and where the costs of entry are high.

A number of past and recent events have reinforced this concern. For example, in 2001, Brixton prison—then publicly held—was market tested. This was the first (and only) example of a fully operational, publicly built and run prison being opened to private competition. However, no private sector bids were received. The poor condition of the prison led potential bidders to consider the contract to be commercially unattractive.

Performance testing of under-performing prisons was introduced in 2000, with the aim of achieving value for money in operational delivery of publicly run prisons. Under the scheme, under-performing prisons were given 6 months to plan and agree necessary improvements, without external bidders. If successful, the prison would be awarded a Service Level Agreement (SLA). If the plan was deemed unacceptable, or if the prison failed to deliver on its SLA, the prison would be opened to private sector bidders alone. A total of eight prisons were performance tested between 2002 and 2004. All were offered five-year SLAs.

The performance testing of a group of underperforming prisons after initial indications that they would be put out to market might have seemed rational from the government's perspective, with the threat of going to market enough to drive improvements within the prisons without all the bidding costs associated with open competition.

However, they resulted in private suppliers feeling that they had been denied an opportunity to bid when if it were their prisons that were underperforming that

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<sup>15</sup> There may be good reasons for this – see the discussion of competitive neutrality below)

is precisely what would have happened. While all the prisons concerned were adjudged to have delivered on their SLAs, not all private suppliers share full confidence in the integrity of that process.

The recent cancellation of the procurement for Maghull prison following the election of the coalition government after a long and costly bidding process (and the announcement of a successful bidder) and the withdrawal of plans to build a large new prison at Runwell sent a signal that an invitation to tender might not lead to the award of a contract, potentially discouraging new entrants from entering the market.

A number of competitive neutrality issues<sup>16</sup> were raised in interviews, including a belief that public sector bids have, in the past, been inherently advantaged in the evaluation process in not having to account adequately for pay and pensions, insurance and central overheads<sup>17</sup>. There has also been concern that incumbents have been advantaged by greater access to information when contracts have been put out to tender.

MOJ is one of the government departments to have taken deliberate steps to address these and other competitive neutrality concerns, issuing principles of competition to accompany the 5-prisons bidding process,<sup>18</sup> including a commitment to provide all relevant information in a timely manner to try and reduce any incumbency advantages.

One of the results of the principles document has been the decision by the MOJ to separate its regulatory, commissioning, procurement and bidding functions into different departments to try to avoid any conflicts of interest that arise when assessing public, private and third sector bids. While this is a positive step in terms of protecting competition, it may reveal a trade-off in terms of the benefits discussed above which flow from having commissioners and procurers working closely together.

Alongside competition for the market is limited competition in the market. With prisoner movements decided nationally, private sector-run prisons are kept full as (a) they are in good condition and (b) PFI repayment terms mean that the payments are based on capacity. The unbundling of DCMF contracts might thus allow greater room for increased competition in the market in future years, although other policy objectives such as those relating to security or the desire to house a prisoner close to their family, will

remain strong factors in deciding how to allocate prisoners.

The MOJ recognises that it is still learning how to reap the benefits from intelligent outsourcing. For example, it has always had a requirement to provide on-line retail services for prisoners, which used to cost money to provide. This service has now been taken to market, with private operators of prisons now asking to use the same contracts as they cannot compete with the prices. We understand NOMS' commercial teams are looking further at alternative opportunities to unbundle services.

### Wider context

Respondents reported that there is an expectation in government that the shifts towards payment by results (PbR) will encourage innovation as suppliers shift their focus from outputs to achieving positive outcomes. PbR is seen as challenging by suppliers. With payments linked to reoffending rates, suppliers question the extent to which they can legitimately be seen to impact those outcomes given that many of the offenders that pass through their prisons do so for only part of their sentence.

Third sector organisations have provided offender management and rehabilitation services inside prisons and post-release, particularly in institutions controlled by the private sector for some time. With payments increasingly linked to results it is hoped that they might come to play a more prominent role in public run prisons too, with those prisons incentivised to see the benefits of a mixed delivery chain.

A six-year pilot is underway at HM Prison Peterborough with a social investment bond providing finance for a rehabilitation scheme with any payment to investors linked to reoffending rates. This is the first example of such contract in the UK.

PbR is much discussed at the moment, with suppliers and commissioners in discussion about how best to implement it. However in general, new government initiatives and announcements are seen by suppliers as too high level and lacking in detail to have any imminent impact on them.

The current economic environment has, however, had a big impact in the current live procurements exercise to procure five prisons, with commissioners deciding to direct bidders towards submitting proposals at the lower end of the acceptable cost range.

The MoJ has gathered sufficient data relating to cost and performance to allow some limited benchmarking to take place, helping commissioners understand what can be delivered on different budgets and narrow that acceptable range.

<sup>16</sup> Competitive neutrality is the principle that competition between different suppliers – in this case public and private – should take place on a fair basis.

<sup>17</sup> The CBI's 2008 paper, 'Counting the cost: Full cost comparison between public service suppliers' highlights this as an issue across the public sector. The level of pensions uplift is centrally mandated by HM Treasury.

<sup>18</sup> 'Competition in mixed markets: ensuring competitive neutrality. Office of Fair Trading Working Paper' (July 2010)

# Case Study 2

## Adult residential care home places

### Key findings

1. The residential care homes market is a “buyer’s market”, providing local authorities with influence.
2. Local authorities are increasingly taking on a strategic commissioning role, but appear to lack a full understanding of the impact of their decisions on the market, with a short term focus on price resulting in swings in cost and quality.
3. The personalisation agenda is giving individuals more choice over their care. The effect on care home revenues is uncertain, while there are accompanying questions about the availability of the necessary information and support required for citizens to exercise choice effectively. Without good information increased consolidation may be a risk with individuals choosing to purchase from larger ‘branded’ suppliers.
4. The driving down of fees, falling property prices, ending of block contracts and increased role for customer choice contribute to a challenging set of market dynamics. Exit from the market is a significant risk.

### Market overview

#### What was bought?

Residential care home places<sup>19</sup>.

#### Who bought the places?

Local authorities; private individuals; primary care trusts; individuals with personal budgets.

#### Who provide the places?

80% private sector; some third sector and self-supply.

#### Size of purchase

Purchases range from short term single places to large 10-year block contracts.

#### Size of market

There are a large number of suppliers, ranging from national chains to single, small, family run homes. Three suppliers provide 24% of places, more than the next ten suppliers together.

### Procurement process

Open tender; framework agreements.

### Background

A care home is a place where personal care and accommodation are provided together. People may live in the service for short or long periods. A home registered simply as a care home providing personal care will provide help with mild care needs, such as assistance with washing, dressing and the provision of medication. A home registered as a care home providing nursing care will also have a qualified nurse on duty twenty-four hours a day to carry out nursing tasks. Both the care that people receive and the premises are regulated by the Care Quality Commission.

Since the early 1990s, the public sector has steadily reduced its role in the direct provision of residential care home places, with local authorities instead commissioning places from private sector suppliers, often through the purchasing of block contracts. Private suppliers now supply over 80% of beds nationally.

The greater role for the private sector has led to considerable market consolidation in what remains a fragmented market, on both the demand and supply side.

Four provider chains supply 24% of beds across the country, but the remainder of the supply side is extremely fragmented.

Local authorities currently buy a little over 50% of places, often through block buying, with the remainder bought by private funders and the NHS.

Local authorities are reported to be trying to take on a more strategic commissioning role, especially in light of the Government’s personalisation agenda, with personal budgets likely to be increasingly used in future years.

While eligibility thresholds (in terms of income and wealth) for state funded domiciliary care are set by local authorities, eligibility thresholds for residential care home places are set at a national level, based on the individual’s income and capital assets.

Many local authorities offer a flat rate payment to all local suppliers. Where this does not meet the price being charged by the home (which, in many cases it

<sup>19</sup> The OFT published a study of the care home market in 2004, including a number of findings and recommendations that remain relevant today.  
<http://www.of.gov.uk/OFTwork/markets-work/completed/care-homes1#named3>

does not), customers must top-up the state funding from their own savings or choose a lower cost provider.

## Policy context

The central theme in ongoing attempts to transform adult social care is an increased focus on personalisation, with citizens who have social care needs given increasing control over the care that they receive.

Increasingly, personal budgets, calculated on the basis of assessed need, are being awarded to people who need care, enabling them to choose whether to use them for funding a place in a care home or to purchase domiciliary care in their own home.

Users can either take their personal budget as a direct cash payment, or leave councils with the responsibility to commission the services. Direct payments cannot yet be used for residential care homes.

Despite this limitation, the introduction of personal budgets is resulting in a dramatic shift in demand patterns, with the individual consumer gradually replacing the local authority as the chief purchaser of care home places. Nevertheless, local authorities currently retain an influential commissioning role.

Policy changes in other areas are also having an impact on the demand for care home places, with primary care trusts increasingly buying places in care homes for those patients who do not need to stay in hospital but who require continuing care.

## Findings

### Objectives and wider context

Our evidence from interviews suggests that the focus of local authorities is overwhelmingly on the short term and on price. That is a tendency that has been magnified by the current fiscal environment, but most of the interviewees we spoke to suggested that the short-term focus is something that predates current pressures.

One of the causes of this situation is the way in which some local authorities approach budget cutting exercises. One authority we spoke to told us that cost savings are often pushed through the whole organisation in a very top-down manner, without taking into account the potential impact on the market.

*“We were essentially told, ‘Adult social care – we want you to find 15% this year’, which immediately affected what we felt able to pay in the market.”*

As outlined below, the lack of a longer-term approach can result in unintended consequences and cycles in the market – including takeovers, cross-subsidy and failure.

Larger suppliers told us that they are much more optimistic about the prospects for those of their homes where the reliance upon state funded customers is lowest.

### Incentives

Commissioners described the challenge set for them as avoiding safeguarding violations, while operating within budget constraints.

While “place based budgeting” encourages the pooling of local resources to see how they may be best spent, commissioners we spoke to did not feel incentivised to think about wider public sector costs. So, for example, one of the reasons that a local authority will look to provide domiciliary care rather than residential care is because it is much cheaper. However, it will frequently also impact on the budgets for housing and other benefits.

### Skills and market engagement

Commissioners, procurers, suppliers, and wider experts all agreed that the commissioning and procurement skills required to adequately understand and take into account the impact of decision-making on the market were widely lacking; this was not seen as a core competency of those who typically choose to pursue careers in adult social care.

While there has been an effort to provide support to commissioners of children’s services, such as the Department for Education’s Commissioning Support Programme (CSP), there is no national equivalent for commissioners of adult care.

Questions were also raised about the standards of contracting skills among procurers. For example, one local authority told us it pays 80% of bed costs, even when the person they are paying for has gone into hospital (and the PCT will, at the same time, be paying even greater amounts for that person’s stay)<sup>20</sup>. A recently appointed commissioner described his surprise to find that the local authority had block contracts with five different suppliers, each for different lengths of time (including one for a 25-year period) and with different terms and conditions.

A recent study investigating the perceived and expressed motivations of care home suppliers highlights the importance of good market

<sup>20</sup> This example highlights both a lack of contracting skills and a lack of coherence across different public bodies.

engagement<sup>21</sup>. The researchers found that commissioners' perceptions differed widely from suppliers' expressed views. In the absence of serious market engagement, those perceptions can be an important source of misinformation.

### Information

Information will become increasingly important in future years as individual consumer choice becomes the main driver of competition, with personal budgets becoming much more prevalent.

Currently, where one would expect competition to be driven by price and quality, in many instances this is not the case. When we asked a commissioner why a care home would still thrive with low quality ratings and high prices, he explained that this is partly due to people (particularly private funders) not being sufficiently well-informed, and partly due to other factors: "One of the worst care homes in our area is also one of the most expensive. But it has a big chandelier in the lobby and a fancy staircase. That's what people see when they go to visit".

The impact of uneven information has other effects on demand too. Currently, self-funders tend to enter care homes earlier than those who are publicly funded. There are two reasons offered for this.

In some cases, entering residential care earlier will be the result of customer choice<sup>22</sup> – the implication being that those who are *publicly* funded are entering homes later than they would ideally wish to, most likely because of local authorities pointing them towards cheaper domiciliary care for as long as possible.

However, others argue that the logic is in fact the reverse. This line of reasoning suggests that the local authority has less reason to engage with those who are self-funded, and that only a lack of information about domiciliary or community-based care options results in those self-funded citizens choosing to enter homes at the point at which they do, while those with access to public funding and information are better placed to exercise their preference for staying in their own homes for longer.

### The market

At a national level, fragmented demand for a commodity service leads to significant variations in both price and quality. But at a regional level, as the

major buyer, local authorities are able to exert a strong influence over price, with both local authority and supplier interviewees agreeing that it is a buyer's market. However, the extent of this influence will vary from one area to another, with some suppliers increasingly focusing on affluent areas with more self-funders.

Substitute markets do exist in some places (for example in coastal towns, where some smaller properties have flipped between being residential homes and holiday bed and breakfasts.) However, in most areas, local authorities exert great control over price.

Evidence from those we spoke to suggests that local price fluctuations result in two different cycles;

At the same time as controlling price, local authorities also exert control over capacity, with evidence that when budgets are tight, local authorities will slow down their processing of applications as well as doing more to direct people to taking up less expensive domiciliary care.

What emerges is a picture where, when local authority budgets are healthy, both price and demand are high, and when they are not, suppliers are getting fewer customers through the door as well as less money for them. This cycle makes it particularly difficult for smaller operators to survive, and explains some of the consolidation that has taken place in the market. An accompanying concern is whether exit is being driven by the right factors, with some of those smaller operators offering high quality care.

Furthermore, with local authorities driving down price as far as possible when budgets are stretched, care homes increasingly look to self-funders to sustain their revenues, resulting in those who are privately funded either cross-subsidising publicly funded places or being priced out of the market and unable to access the required level of care.

A second cycle occurs as a result of a shifting focus between cost and quality. Price gets driven down by local authorities and, when pushed too far, this results in a lower quality service in care homes. Once this comes to light through a mixture of customer surveys, complaints, Care Quality Commission inspections and safeguarding reviews, the focus switches towards quality in the next round of contract negotiations and prices creep up again.

Suppliers we spoke to all complained about a lack of clear strategic direction from local authorities, resulting in market inefficiencies and difficulties in planning.

Suppliers reported that while some commissioners go to great efforts to engage with them and help them

<sup>21</sup> 'Motivation and commissioning: perceived and expressed motivations of care home suppliers', Matosevic, Knapp and Le Grand (2008)

<sup>22</sup> The 'customer' is not easily defined in this market. Sometimes it will be the person moving into the home, while at others it may be a family member purchasing on their behalf. Those entering care homes can sometimes be too frail to exercise choice themselves.

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predict and plan for changes in demand, prices and expected standards, the majority do not. Primary care trusts were described as doing very little market engagement. One supplier reported asking for better engagement from the local primary care trust, but was told that procurement rules would not allow 'favourable treatment'.

A commissioner from a large local authority reported that his authority sees the future as a free market with customers with personal budgets or private funds buying directly from the provider, with the local authority only intervening to correct market failure: "For us, going through procurement processes takes so long that it stops us from being able to respond quickly to the market".

Block buying by local authorities was attractive for suppliers as it guaranteed them committed volume. But with consumers now able to exert greater control over where they go, this practice is rarer now, with councils finding themselves effectively paying twice if a customer chooses to go elsewhere.

### Wider issues

Changes in demand and price are also being unintentionally driven by other less direct policy levers. For example, existing data suggests that, as well as going in earlier, self funders also stay slightly longer than those who are state funded. This may be a result of variations in health among those for different socio-economic backgrounds. But some have suggested that it is a result of those who are publicly funded on occasion not going in at the point they need to, resulting in quicker throughput into hospital or more specialist nursing homes.

Likewise, primary care trusts are increasingly looking to care homes as cheaper destinations for those being released early from expensive hospital beds. They are attractive customers for care home operators as they tend to pay higher prices than the local authority.

The future for care home suppliers is particularly uncertain at the moment.

On one hand, there are an increasing number of older people, with more assets than previous generations of old people. Furthermore, there is an increasing number of beds being bought by the NHS.

On the other hand, there is an increased policy focus on trying to keep people at home as they get older, partly because it is cheaper and partly because it is seen as better for the well-being of older people.

While in the past fluctuating prices have been particularly difficult for smaller suppliers to bear, increasingly the larger suppliers are under pressure too. This is partly due to local authorities pushing

down price, but large suppliers have also come under pressure from falling property prices (meaning a significant fall in the value of their business) and rising rents, which have affected a significant number of providers who have sold off their property and leased it back.

In light of these developments, interviewees highlighted the need for strong market engagement both at a national and local level as well as a strategy to ensure continuity of supply in the event of a larger supplier exiting the market.

# Case Study 3

## Schools' goods and services

### Key findings

1. Buying power is fragmented both across and within schools.
2. Joint procurement exists at a regional level, with Public Sector Buying Organisations often being the preferred supplier for many schools.
3. Private sector penetration is low in many parts of the country, with school buying decisions often driven by trust in public sector institutions and local suppliers, and by convenience, as much as price and other aspects of quality.
4. Respondents reported that increased school autonomy may reduce the potential for centralised efficiencies, but over the longer term is likely to make schools more commercially aware.

### Market overview

#### What was bought?

A range of general and curriculum-related goods and services, including text books, stationery, furniture and energy.

#### Who bought the goods and services?

Schools; Public sector buying organisations (PSBOs).

#### Who provided the goods and services?

PSBOs; Private sector 'one-stop shop' suppliers; individual, niche suppliers.

#### Size of purchase

Varied, from a handful of textbooks to larger furniture/energy orders. Equivalent to around 20% of school budgets.

#### Size of market

There are two main private sector 'one-stop shop' suppliers. Most parts of the country are covered by at least one local public sector buying organisation.

#### Procurement process

Open tender.

### Background

The Department for Education's recent paper, 'Improving Efficiency in Schools', argued that:

*'Procurement is a particularly important area for making efficiency savings in schools. Indeed, the Spending Review announcement said that schools could save as much as £1bn through smarter procurement and back office spending'.*

However, a greater focus on efficiency has come at a time when schools are increasingly being encouraged to see themselves as autonomous.

Schools procure a range of goods and services, from stationery and text books to catering services and energy. Historically, schools bought all of their goods and services direct from their local authority, who traditionally operated stores operations, buying in bulk in order to supply the schools within the authority's boundaries.

The first significant change in legislation came in with the 1970 Local Authorities (Goods and Services) Act, enabling local authorities to provide goods and services to other public sector organisations, simultaneously allowing the sector to benefit from buying at scale and from the development of concentrated procurement expertise.

This allowed former local authority stores operations to morph into PSBOs owned jointly by groups of neighbouring local authorities.

The 1988 Education Reform Act allowed schools freedom to buy from wherever they choose, including, for the first time, private suppliers. The introduction of the Direct Schools Grant approximately five years ago sealed full autonomy for school funding.

In 1991, a court action was brought by the private sector against the largest of the PSBOs. The action was defeated, establishing the right of the PSBOs to operate at a profit across regions and buy stock without having orders.

In 2005 the largest five PSBOs came together to form Pro5, made up of four full consortia (with pooled procurement activities) and one looser arrangement between 13 local authorities, where any one of the authorities might go to market with aggregated requirements.

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## Findings

### The market

Buyer power is extremely fragmented both across and within the 23,000 schools in England and Wales.

Within schools, most non-curriculum buying decisions are made at the level of the school bursar, secretary or, where there is one, school business manager. Curriculum related purchasing decisions are often made by individual teachers or heads of department.

Schools are completely autonomous buying organisations. While there are some examples of schools coming together to purchase goods and services collectively, there is no large scale formal aggregation.

Schools have traditionally bought a reasonably generic range of services from their local authority (including HR support, payroll, catering, etc) and often have access to local authority contracts for things such as waste and stationery. However, this varies from one local authority to another. Some local authorities are moving away from including schools due to a lack of procurement resources, and others are seeking more involvement in order to secure funds from schools or better deals on contracts through aggregation.

Occupying an interesting dual role as buyer and supplier, PRO5 cover a large part of the country and over half the schools in England, with the exception of a corridor leading down from the Midlands, through London and into the South West.

In the areas they cover, PSBOs have a significant share of the market for school supplies, and are increasingly providing services too, acting as a one-stop shop for most of the purchases a school needs to make.

There are private sector alternative 'one-stop-shop' suppliers, with two main suppliers. The private sector has seen considerable consolidation, with one of the suppliers having bought up a number of smaller suppliers and ex-local authority stores and the other also having a legacy in the public sector.

Interviewees reported that PSBOs tend not to supply regions that are already covered by another PSBO, but there is competition between them in other areas of the country.

While there are a small number of national contracts, some we spoke to questioned whether the relative lack of nationally negotiated contracts is being sufficiently compensated for by strong competition among suppliers.

Commercial suppliers understand that schools will always honour their debts and that they will not go

bankrupt so this can be an attractive market to enter. But it can be difficult to penetrate, partly because of a tendency described below for schools to favour public sector suppliers, but also because of a suspicion among private sector suppliers that they are not operating on a level playing field, with a perception that PSBOs are either being subsidised by the local authority in some way, or at least not driven to the same efficiencies as private sector suppliers by less demands to make a profit.

Buying patterns among schools can also make it difficult for commercial operators, with major peaks around the school holidays, with other times of year much quieter.

### Objectives, incentives and wider context

The Government currently has a desire to drive greater efficiencies from public procurement, but also wants to devolve power down to individual schools and increase their autonomy and accountability. In the longer term, greater accountability and control may lead to the kind of behaviours in schools that promote efficiencies, such as more focus on price and working collaboratively with other schools. But in the shorter term interviewees agreed that there is a potential trade-off between the two objectives, with the Department's policy to prioritise school autonomy.

PSBOs are difficult to categorise precisely with respect to their objectives. On the one hand they see themselves as buying on behalf of schools, which was their historical role, trying to secure as good a deal as possible for the schools in their areas. On the other hand, they are increasingly commercially minded organisations seeing schools as their customers, and looking for areas to expand into.

Private sector suppliers perceive this dual identity as leading to difficult conditions in which to compete. Schools have historically tended not to see themselves as professional buyers – their main role being as institutions devoted to teaching and learning. Respondents said schools have tended instead to see the PSBOs as an extension of their local authority – a natural, benevolent supplier from within the public sector. Furthermore there is a large degree of inertia among schools, with many of them sticking with the suppliers they know and are comfortable with.

With non-pay spend amounting to less than 20% of school budgets, price appears to be lower down the list of objectives than is often the case. Valued much more highly are good, reliable service, trust, and quality. Interestingly, both the PSBOs and their private sector competitors told us that their competitive edge is mainly around service. Respondents reported that good service can mean different things to different schools. Some like the private sector type service, with shorter delivery times and more order channels. But

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many value more traditional order methods and trusted, familiar local faces and suppliers, reinforcing their sense of being part of a local community.

Schools can be sceptical about national or large scale contracts and arrangements, particularly in harder to reach parts of the country. The Department's attempt to create an on-line 'eMarketplace', 'OPEN', to drive efficiencies and greater choice did not take-off, partly for this reason, even though when logging in the schools would only see their own 'universe' of suppliers<sup>23</sup>.

The PSBOs each operate under different business models, with some aiming to break even and others to make a profit, most of which is usually pumped back into the local authority, rather than being passed on to schools through cheaper prices. While not operating under great competitive pressures, at least one PSBO incentivise its staff with profit-related bonuses. Perhaps unsurprisingly, this was the PSBO that appears to have done most to drive down the prices at which they buy, going direct to source in the Far East for some products. However, these profits were passed back to the local authority, not on to schools. One reason given for this was "if my prices were too low, schools wouldn't trust the products."

While there can be some price sensitivity in schools, both public and private sector suppliers tend to offer deals at various times that can make price transparency more difficult, especially with less savvy buyers. One local authority we spoke to told us that, at one stage, when managing energy contracts for schools, they would get the energy companies to charge extra to the schools and give them a rebate. The schools were still saving overall, but were not provided with the most transparent service.

There have been reports from PSBOs of some local authorities (even within their territories) not making use of them, with departments concerned that losing their buying function will potentially mean losing their power within the organisation or even their jobs.

Over the coming years, this picture is likely to change. Greater autonomy, more knowledgeable school business managers and more academy chains are likely to make schools more sophisticated and selective buyers.

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<sup>23</sup> To be registered on OPEN and visible to local schools, suppliers had to be nominated by the local authority or a school within that local authority

# Case Study 4

## NEST scheme administration

### Key findings

1. Unbundling separate requirements was important in driving the procurement strategy and engagement with the right suppliers.
2. Involving the procurement team in top level discussions, and making sure the right mix and level of skills was available, helped drive an intelligent procurement process and a positive outcome.
3. Extensive engagement with bidders, careful management of the process and active provision of feedback fostered open and constructive relationships.
4. The political and economic contexts were important, creating additional risk to suppliers.

### Market overview

#### What was bought?

Administration services for a large new pension scheme.

#### Who bought the services?

Personal Accounts Delivery Authority (PADA), a non-departmental public body of the Department for Work and Pensions (DWP).

#### Who provided the services?

An international IT solutions, business services and outsourcing company.

#### Size of purchase

£600m over ten years.

#### Size of market

There are only a few such large pension schemes in the world. However, PADA did not set out to procure a pension scheme but rather the constituent business services, for which there are large existing markets.

#### Procurement process

Competitive dialogue.

### Background

The Personal Accounts Delivery Authority (PADA) was established as a non-departmental public body under the Pensions Act in 2007, to help implement the then government's pension reforms. Under these reforms, all employers will have to automatically enrol eligible employees into a "qualifying pension scheme" that meets certain requirements set out in law. These employees will have the right to opt out, but if they stay in then they and their employer will have to make minimum contributions. These requirements will begin to come into force from 2012 and will take effect over a number of years.

PADA's responsibilities included designing and procuring the services needed to run a large new pension scheme, known at the time as Personal Accounts but now called the National Employment Savings Trust (NEST). NEST has a universal service obligation so any employer that wishes will be able to use it as a means to meeting its new legal requirements. It is expected that several million people will join the scheme and it will soon become one of the largest pension schemes in the world. In July 2009 PADA handed over its responsibilities to National Employment Savings Trust Corporation, which is responsible for the delivery of the Scheme and its operation.

It is too soon to know the full results of PADA's procurement exercises, but the approach taken provides useful insights.

### Findings

#### Objectives

DWP had decided to buy rather than to build the capability of a pension provider without, at that time, having decided whether this should be achieved through out-sourcing to a single supplier or via disaggregation to a number of suppliers. It was reported that government lacked relevant experience and that early estimates indicated it would have proved more expensive to do the necessary work in house:

*"[The procurement approach] utilises the skills, expertise and capacity of the private sector to develop, build and deliver."*

It was also reported that the decision was driven in part by a desire to transfer risk to an external provider.

The most critical factor driving the procurement process was the relatively short amount of time available to procure the services and deliver a functioning pension scheme. This is explored in more detail in the section entitled 'Procurement Process'. While cost was also an important factor in the procurement process, quality and reliability were critical, given NEST's high profile and potential impact.

### **Requirements, bundling and market engagement**

A key phase of the procurement process was gaining a detailed understanding of what would be required to successfully run NEST. The early stages of setting out these requirements, and initial market testing, were conducted by DWP before PADA was set up. In these early stages, DWP was talking predominantly to established providers of out-sourcing services to the public sector.

PADA then undertook more detailed work to develop its requirements and consider potential supplier markets.

PADA recognised that using a large integrator to act as a prime contractor would have the potential benefit of minimising the number of organisations and contracts that PADA had to manage. PADA rejected this approach in favour of disaggregating its supply chain into four major contract packages. The key driver behind this decision was the recognition that, having decided that the constituent services were better bought than built, it made most sense to buy these services in a configuration that closely mirrored existing market practices. It was also recognised that the use of a prime contractor had the potential to increase costs, because the prime contractor was likely to charge a premium to cover the risk associated with integrating the sub-contractors. It would also have added to the management challenge by creating an additional organisational boundary between NEST and people delivering services for it.

The disaggregation approach does however add financial modelling complexity, making it important that PADA understood the different charging models of the constituent parts of the supply chain in order to produce a robust business case.

Once the packages had been disaggregated, PADA undertook an exercise to determine the appropriate procurement process for each business service.

These decisions led PADA to engage a broader range of markets and suppliers than the established public sector providers. They were critical in driving PADA's

procurement strategy and ultimately in accessing markets in which it found some of its most competitive bidders.

### **Procurement process**

The contract for pension scheme administration was the largest by value. It was also the most complex, with some uncertainty about how suppliers might meet requirements, and was therefore a good candidate for competitive dialogue procurement process.

Respondents from all quarters reported that PADA's approach to the procurement was more sophisticated in several respects than has tended to be the case in other public sector procurement exercises they have been involved in. One participant said:

*"The project objectives drove the procurement process, not the other way around".*

PADA used the procurement process to actively drive down the risk profile associated with delivery of this key element of the service. The most critical risk was the short time available to deliver a pension scheme ready to accept contributions – and one of the key drivers for the lack of time was the necessary length of the public procurement process itself. With this in mind, PADA's comprehensive market engagement process ensured that bidders entered the competitive dialogue process at a canter, with greater clarity around the requirements than in their previous experience of public sector buyers, who sometimes go out to tender too early.

*'Public sector clients often use competitive dialogue as a way of requirement gathering and getting us to do their work<sup>24</sup>.'*

During the process PADA conducted a Proof of Solution exercise, in which bidders had to mimic the anticipated transaction volumes using an adaptation of an existing production system. Throughout the competitive dialogue process, PADA had required bidders to produce multi-thousand line project plans to demonstrate how they would deliver their solution according to plan. Combined with the use of the Proof of Solution exercise, this ensured that the successful bidder already had in place a detailed plan for how it would make the journey from its existing capability to that required by PADA.

<sup>24</sup> This is consistent with the findings reported in HM Treasury's recent Review of Competitive Dialogue (2010)

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This meant that the successful bidder exited the procurement process with the project of delivering the Scheme Administration services already under way.

Another of PADA's key requirements was the predictability of cost. Given inherent uncertainty over member volumes, it was important that PADA had a business case which would be predictably viable across a range of potential outcomes. This drove a substantial amount of the commercial discussions with bidders and the apportionment of risks. PADA agreed with bidders that pricing for delivery of the service should be on a per account basis. During the process PADA required bidders to provide financial models in a number of iterations, which included the pricing of identified risks (whether bidders were minded to accept these risks or not). This provided PADA with a normalised view of prices across bidders with different risk appetites.

Bidders pointed out that taking part in a competitive dialogue process can be an expensive, time consuming process for them, and highlighted the way in which PADA helped by clustering meetings in an intelligent, structured manner.

PADA insisted on dealing with the people on the supplier side who would be responsible for ultimate delivery in order to ensure continuity from the end of the procurement process.

*"I wanted to speak to the guy whose bonus depended on delivering what we needed rather than the guy selling it."*

PADA also actively provided feedback to bidders during the procurement process to allow them to make an evidence-based decision about how able they were to meet PADA's requirements and therefore whether to continue to bid at different points. This decision reflected an understanding of the bidding costs for suppliers and a desire to build a constructive, open relationship with the eventually successful bidder. Interviews with suppliers suggested that they welcomed this openness, and contrasted it with the more 'cagey' approach that can sometimes be encountered when dealing with the public sector.

Despite positive feedback, those involved on both the buyer and supplier sides reflected that in the private sector a similar procurement would have had more flexibility and may have, *"allowed conversations to take place that would illuminate the things that matter even earlier"*.

One outcome which may have been partly driven by this approach was that bidders dropped out of the process before the scheduled formal completion of the dialogue. As well as reducing bidders' costs, this had the advantage to PADA that it could maximise its engagement time with the successful supplier, with

whom PADA ultimately reached an agreement. At the time, PADA was criticised in some quarters for having only one remaining bidder in advance of signing a contract, though this view was not reflected in interviews we conducted.

### Skills

Experience was recruited from the private sector, including a Chief Executive with experience of large scale transformation in retail banking, and combined with public sector experience. This included public sector procurement experts who were known and trusted within DWP and who were sufficiently involved in the core senior team to be at the heart of decision-making. This last fact was recognised by bidders, one of whom told us:

*"We often deal with procurement teams that lack people able to adequately represent the core business. Not in this case."*

### Wider context

In this case, the political and economic contexts were important. The scheme administration contract was due to be signed shortly before the General Election, which respondents felt brought risks to potential suppliers that requirements changed or even that a new government decided not to go ahead with the planned pension reforms. These political risks may have been a factor in potential suppliers' decisions about whether or not to bid. The economic downturn also created risk for the successful provider that the volume of members and contributions could be reduced in the early years of operation by a less buoyant economy (e.g. due to lower employment).

### Entry and exit

The procurement team actively considered the end of contracts and the risk of supplier failure. Because PADA bought business services from a supplier with pre-existing infrastructure, at the end of the contract NEST Corporation will not be left with technological assets. This makes access to the current supplier's systems and people important in ensuring that there is an orderly transition to a new supplier. In the event of an un-planned exit PADA will have more rights to the assets themselves in order to mitigate the risk of disruption to the service. Time was devoted to exit and transferability during the dialogue process and bidders were asked to prepare detailed exit plans which were assessed as part of their bids.

# Case Study 5

## Hospital facilities management

### Key findings

1. Bundling FM contracts in design, build, finance and operate contracts can bring benefits, such as incentivising those designing and building the facility to ensure it is easy to maintain. However, it can also restrict the number of potential bidders and result in a lack of focus on the FM part of the deal, with a focus instead on the building part of the contract.
2. While PFI deals allow for market testing to ensure value for money, many hospital estates staff lack the requisite contract management skills. Good contract management is seen as a bigger differentiator than the decision to outsource or self-supply.
3. Different contracting arrangements and individual hospital autonomy can make it difficult to collect high quality and comparable data, making benchmarking difficult.
4. While there has been an expectation by the Department of Health that hospitals will cooperate where there are mutual benefits, increasing levels of autonomy and competition have restricted the amount of collaborative procurement that takes place.

### Market overview

#### What was bought?

Soft and hard facilities management services, including cleaning, catering and maintenance services. Sometimes as part of design, build, operate contracts.

#### Who bought the services?

Usually individual hospital trusts; occasionally groups of trusts.

#### Who provided the services?

Facilities management (FM) suppliers.

#### Size of purchase

Ranging from large bundled contracts to smaller, occasional niche products.

#### Size of market

There are a limited number of prime contractors; large numbers of sub contractors.

### Procurement process

Open tender.

### Background

Hospital facilities management services are supplied in one of three ways.

- Self-supplied by public sector
- Commissioned directly from the private sector
- Commissioned through Design, Build Operate contracts, usually through private finance initiative (PFI) deals.

It is not uncommon to find a combination of these arrangements simultaneously in one hospital site, particularly where part of the estate was built through PFI.

The role that the Department of Health (DH) and the NHS play in directing and supporting procurement policy in hospitals is in a state of transition.

Under the older 'command and control' model of running the NHS, when the centre could be more directive, hospitals were expected to market test their FM services. The introduction of Trust and Foundation Trust status has left all decisions regarding facilities management in the hands of the Trust itself. Some interviewees perceived a shift in policy and emphasis in 2007 which reduced the pressure on Trusts to continue with the practice, but a further change in government, together with pressures on public funding (the NHS is aiming to save £1.2bn through better procurement), has meant that examining current arrangements has returned back up agendas of the Trusts' Finance Directors.

### Findings

#### Wider context

While a renewed focus on facilities management arrangements can have a positive impact on achieving value for money, a number of our interviewees suggested that spending on estates can too easily be seen as targets for short term savings, in a way that comes at the detriment of long terms strategic and business planning. This is particularly true for hard FM services, relating to maintenance of buildings, etc.

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Soft FM services, by contrast, have come to straddle the line between front and back office, and thus be somewhat more protected when it comes to spending cuts. With cleaning and catering increasingly understood to have an impact on patient safety, satisfaction and other quality metrics, it can also mean that Trusts can be overly cautious about changing their arrangements, especially from in-house provision.

### The market

The demand side for facilities management is very fragmented, with most Trusts buying similar services separately. There are increasing examples of collaboration, but this is more developed with respect to procurement for commodities than it is for services.

This has resulted in something of a corresponding fragmentation on the supply side, with smaller, sometimes local suppliers surviving to supply smaller buyers. This might mean small hospitals or, more often, Primary Care Trusts (PCTs). PCTs may own over 200 buildings, many of which will make their own FM arrangements.

The late 1990s saw the beginning of over a decade of large PFI deals, used as a way of attracting private sector capital into the NHS to help modernise and upgrade the estate and bring improvements to the patient care environment.

This had an effect on the provider market, with large construction and FM groups setting up Special Purpose Vehicles either with their own facilities management arm (with some buying up smaller suppliers) or subcontracting to a preferred partner that they bring with them. The PFI deals include mechanisms for routine market testing or benchmarking of FM services.

With most of the big NHS PFI deals completed, the market may continue to change shape in the coming years, with the possibility of suppliers looking to the smaller contracts that they have previously avoided and pressure on a fragmented demand side to consolidate. However, interviewees suggested that although Trusts are expected to cooperate, they also increasingly compete with one another which, in some instances, reduces the amount of cooperation that takes place.

### Objectives and incentives

PFI deals are usually motivated by a desire to introduce private funding to replace older estates. Interviewees suggested that the focus of commissioners and procurers in these deals has tended to be the high profile new glossy building, with less attention paid to the contracts and costs associated with the facilities management services that are part of the wider deal.

One reason for bundling of the 'operate' together with the 'design and build' is that if a supplier is responsible for managing a building they can be incentivised to design and build it in such a way that it is easy to maintain. However, that will not apply to all services. The other reason will be convenience or arranging everything through one set of negotiations.

Concern was raised by directors of estates we spoke to about whether these facilities management contracts were delivering value for money. One hospital we visited was part PFI and part self-supply, and reported being charged £2000 to move a socket, when it cost £120 on the non-PFI part of the estate. Explanations usually offered are that the cost includes 'lifecycle costs' for the whole duration of the contract. Nevertheless, the feeling persists among interviewees that if you do not look at the FM aspect of the PFI contract until 18 months into negotiations, it becomes impractical to withdraw even if that aspect of the deal is less competitive.

Estates managers we spoke to also felt that aggregating contracts in this way also limited the number of potentially good suppliers that could compete to provide the FM services.

### Information and skills

We asked a number of interviewees if they thought there was better value in outsourcing or self-supplying. While most felt that in an ideal world outsourcing brought better value, a number of people suggested that the biggest differentiator was the ability of directors of estates to manage contracts, a skill which is felt to be lacking across most hospitals. Without these skills, outsourcing may not deliver those savings. A recent NAO report<sup>25</sup> looking at NHS PFI contracted noted that 12% of Trusts do not even have a designated contract manager.

Thus, while value testing reviews, which take place every 5 years within PFI contracts, allow hospitals to challenge what they consider to be unreasonable charges, estate managers are not always well-equipped to do so.

A lack of high quality and consistent data presents an even bigger challenge, with DH unable to compel Trusts to collect and submit similar information, and difficulties in comparing data across different kinds of contracting arrangements (for example part-PFI estates). While DH does attempt to share information to aid benchmarking exercises, it is not uncommon to hear of hospitals whose IT systems do not allow the estates team to run the spreadsheets, or that the team struggle to interpret the data.

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<sup>25</sup> National Audit Office (NAO) (2010), The Performance and Management of Hospital PFI Contracts

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Efforts exist to collect data specifically about outsourced services, but there was concern about placing too much burden on suppliers. This had been useful in highlighting potential local monopolies for some niche services.

A number of interviewees pointed out that recent driving down of the costs made collecting and analysing information even more difficult, both at the centre and locally – *“we’re working hand to mouth on current issues”*.

# Case Study 6

## Flexible New Deal

### Key findings

1. DWP's commissioning strategy allowed for fewer, longer, larger prime contracts.
2. While the administrative burden on DWP fell, the procurement model had the opposite effect on sub-contracted organisations, who now had multiple (and varied) bid documents to fill out.
3. Payment by results is welcomed, but can create cash flow problems for third sector suppliers.
4. A lack of initial clarity about the desired profile of a prime contractor resulted in fewer bidders than anticipated.
5. Fluctuating predictions for anticipated case volumes made it difficult for suppliers to plan.
6. Limited competition in the market means that threats to underperformers need to be credible to avoid unrealistic bids.

### Market overview

#### What was bought?

Welfare to work services.

#### Who bought the services?

Department for Work and Pensions (DWP).

#### Who provided the services?

Fourteen (mainly private sector) prime contractors, supplied by a large number of private and third sector sub-contractors.

#### Size of purchase

Large contracts at the prime level, covering fourteen regions; varied for subs, with very small contracts for niche services.

#### Size of market

Limited number of prime contractors; large numbers of sub contractors.

#### Procurement process

Restricted procedure

### Background

The Department for Work and Pensions (DWP) is the main buyer of welfare to work services in the UK, and Flexible New Deal (FND) is one of its biggest initiatives to date. Under FND, DWP commissioned fourteen prime contractors to provide back-to-work help to Jobseeker's Allowance claimants.

Following the publication of its Commissioning Strategy in 2008, DWP has sought to move to a procurement model in which it contracts with a smaller number of large prime contractors for longer periods, and those 'primes' subcontract to a range of subcontractors. Primes were expected to bring a network of subcontractors and so ran their own procurements to put this supply chain in place. Approaches varied by prime, both in terms of the extent of self-supply, and the process used to recruit and manage subcontractors. Third sector organisations are a significant part of FND delivery, particularly as subcontractors.

While UK employment and training programmes have been outsourced since the 1980s, the New Deal programme in 1997 marked a significant restructuring of the provision of welfare to work services. In general, the programme was characterised by basic, work-focused interventions for those out of work, with more personalised and intense interventions as the duration of unemployment increased.

The following years saw a series of programmes with a growing role for the private and third sectors in delivering welfare to work services, allowing for a greater range of provision supporting return to employment. For the most part these were in addition to state services, which focused increasingly on new claimants and short term (frictional) unemployment, with personalised help for longer term unemployed jobseekers being bought from private and voluntary sectors.

FND was introduced in October 2009. It reflected DWP's aim to take on more of a strategic commissioning role and reduce the growing administrative burden involved in contracting directly with a large number of suppliers, while continuing to promote an approach involving more flexible, outcome-based provision in welfare to work services and a sufficiently rich supply chains to offer a personalised service to a range of clients.

DWP's Commissioning Strategy also set out a plan for:

- the use of outcome-based funding and ‘black box’ contracts, whereby suppliers are given greater flexibility as to the attainment of target outcomes; and
- competition for and within regional contracts, enabling ‘like-for-like’ comparisons between suppliers and appropriate redistribution of market share.

Under Phase One, 14 regional lots and 24 contracts were awarded to prime suppliers and their supply chains.

Flexible New Deal was cancelled by the new Government in October 2010.

## Findings

### Market

Prior to the commissioning of FND, the welfare to work market appeared mature, with low market entry; 60% of suppliers had been operating for over 10 years.

FND successfully increased market entry at both the sub and prime levels, with three of the fourteen successful primes being new to the UK market and one new to welfare to work services. However DWP officials indicated that they struggled to attract as many new primes as they would have liked.

Most primes had previous experience with a PbR system, with interviewees speculating that those who did not bid may have preferred to observe the first round of contracts before taking on the associated risks.

Supply chains varied amongst primes. While later DWP became firmer in its desire to see rich, mixed supply chains with a strong role for the third sector, in FND the picture was mixed, with some primes self-supplying, and others operating more as management agencies for subs. While DWP has clarified its position, this does remain an area of concern for subs. One interviewee said:

*“It is inevitable that primes will come to think exactly what DWP did – it’s easier, cheaper and less risky to work with fewer suppliers. Only time will tell if DWP stay committed to mixed provision.”*

This concern was born out for some by incidents of primes bidding with subs with whom they did not subsequently contract. However, one prime did express the view that being involved in delivery themselves helps them better understand the challenges of their subs.

Significant overlap existed between supply chains, with 7 of the 14 FND primes subcontracting to other

primes, and over 1 in 5 subs offering services to more than one prime. DWP helped facilitate these relationships by holding ‘speed dating’ events around the country. While these were widely welcomed, there were some complaints about the burden placed upon smaller organisations that had to attend numerous events.

While prime and sub-contractors we spoke to were supportive of the prime-sub model, concerns were raised about sub-contractors maintaining their freedom and identity in the future. One sub-contractor reported bidding with two different prime-contractors who both won contracts in the same area (more than one prime could win each area in order to promote competition in the market). It was subsequently agreed that it would be best if they only worked with one of the primes concerned. While in this case it was reportedly due to the administrative difficulties that working with two primes in the same area could cause, it nevertheless left a potential concern about primes influencing who subs can work with.

Some consolidation has already taken place in the market, and that is expected to continue. While the subs we spoke to felt that driving them to become more commercially accountable was a good thing, there have been concerns from some in the sector worry that an increased commercial focus will inevitably drive out some third sector organisations’ ability to act as advocates and campaigners.

### Market Engagement

An additional reason offered by those we spoke to for why more potential primes were not attracted to bidding for contracts is the uncertainty that a number of organisations reported about the precise requirements for being a prime, which they said arose in part because DWP itself was not clear about the desired profile. Respondents reported a tension between a desire to be both laissez-faire and to steward the market. One interviewee expressed the view that this reflects a wider challenge that is faced across government as departments continue to move away from delivery and towards a commissioning role:

*“Most of us in government know how to buy things that everybody else buys. But where the difficulty lies, culturally as much as technically, is in commissioning services whose delivery has previously been part of our core function.”*

A reluctance to ‘let go’ was mentioned by two suppliers we spoke to, arguing that where DWP had originally recognised that fewer specifications would leave more opportunity to innovate, as time went on

*“It couldn’t help itself from attaching conditions that were related to inputs not outcomes.”*

Another reported tension related to information is the issue of learning from success. The OFT's 2010 report on choice and competition in public services<sup>26</sup> included a case study on 'employment zones', highlighting that the existence of multiple providers provides an opportunity to learn from successes and share that knowledge more widely. In the case of FND this was helped by the fact that all prime suppliers and most subs had performance monitoring systems in place, capturing both quantitative and qualitative outcomes. The programme was discontinued before any substantial lessons could be learned. But two potential challenges were anticipated by respondents. The first is a vertical challenge, with subs concerned that if primes pick up too much of their specialist knowledge they will eventually stop sub-contracting. The second is a horizontal challenge, with individual primes not wanting to lose their competitive advantage by seeing their operating models shared more widely.

One of the core difficulties experienced in FND was getting accurate information about the expected volumes of potential clients. Initial estimates were raised by 40% in the middle of the negotiation process as the economic downturn presented an emerging threat to jobs. These estimates were soon drastically reduced again, all of which made planning difficult. While there was some understanding from suppliers regarding the circumstances, there was still a feeling that it could have been handled better.

The original plan was for FND to be introduced in two phases, each covering about half the country, with more disadvantaged areas disproportionately represented in first phase. The new government first cancelled the letting of the second phase and then also the contracts already let in the first. The latter was reported by suppliers as having an impact on how they viewed the risks associated with contracting with DWP.

### Skills

Suppliers used a range of financial modelling techniques to appraise contracts. Primes used at least five models (e.g. modelling case loads, length of time on provision etc.), while many unsuccessful bidders used fewer. The depth of technical expertise suppliers brought supported the aim of the commissioning strategy to promote high performing supply chains.

There was a perception among suppliers that, while the Department had developed a good understanding of its wider role as a market shaper, it lacked sufficient understanding of commercial realities for suppliers associated with a programme of this scale. For example, failing to allow sufficient time between

announcing winning bids and signing contracts (to let primes/subs finalise arrangements) and between signing contracts and the programme going live (as leases cannot be signed until contracts have been finalised). There were related concerns about DWP's IT systems for transferring payments not going live on time, with one supplier claiming

*"It just wouldn't have happened outside of government."*

### Incentives/objectives

For suppliers FND marked a shift towards payment by results (PbR)<sup>27</sup>. Most primes had previous experience with payment by results, but subcontractors generally did not. While a number of prime suppliers adapted their payment systems and terms and conditions to reflect the nature of subcontractor provision, i.e. end-to-end or specialist, niche provision, this did not guarantee volumes for subcontractors. Some subcontractors left the market before contracts were signed and one closed after the programme had gone live.

Respondents reported that payment by results does bring particular challenges for smaller, third sector suppliers. Concerns were raised about milestone payments and the negative cash flow problems these can cause. Furthermore, while respondents reported that payment by results is attractive because of the belief that it incentivises innovation in search of high performance, getting payment milestones wrong and creating too many burdens can have the opposite effect.

There were questions raised about the balance between cost and quality. Some perceived that too much focus on cost may incentivise bad behaviours with bidders bidding too cheaply. This strengthens the importance of DWP being prepared to let suppliers fail, and the accompanying importance of ensuring there is sufficient competition in the market to allow for that eventuality.

### Governance/controls

The Merlin Standards<sup>28</sup> were designed by DWP with suppliers and representative bodies to help promote high performing supply chains and positive behaviours and relationships in the delivery of provision, ensuring the fair treatment of all organisations within those supply chains. While there has been limited opportunity and need to enforce the standards, they are seen by the suppliers as sending a

<sup>26</sup> OFT, Choice and competition in public services (2010)

<sup>27</sup> DWP had already started to explore the use of a PbR approach, for example in Pathways to Work. But FND represented a large expansion of this approach.

<sup>28</sup> <http://www.dwp.gov.uk/docs/sub-contracting-merlin-standard.pdf>

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strong and positive message, and have gone some way towards meeting concerns of smaller third sector organisations that had previously contracted directly with DWP.

However, a point highlighted by one prime was that while Merlin protects smaller organisations from improper behaviour by prime contractors, it does not set out any commitment or standards for DWP itself to adhere to. This was seen as important as DWP is in a position to influence the burdens placed on suppliers and ensuring an appropriate balance is struck between risk and reward.

Other burdens reported included onerous information security requirements placed upon bidders by DWP and – a big issue for subs - the lack of common Expression of Interest documentation<sup>29</sup> required by different primes of potential subs, which creates a significant barrier to entry.

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<sup>29</sup> An Expression of Interest is a call to potential providers of goods and/or services to register interest in supplying them.

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# International welfare to work experience

## New York<sup>30</sup>

Over the past two decades New York has introduced a range of welfare to work reforms including a redesigned sub-prime commissioning and contracting structure and payment by results, but with interesting differences of approach to the UK context.

Welfare assistance in New York is the responsibility of the HRA (Human Resource Association) who, through a network of around 30 local State-run job centres, provides welfare payments and back to work services.

The late 1990s saw a shift from the obligation for unemployed welfare recipients to attend work experience programmes (WEPs), usually involving work in public agencies, to a blended 'three-plus-two' approach, combining three days of WEP each week with two days of developmental training designed around specific client groups.

The initial commissioning process was run by 'negotiated acquisition', which allows a degree of dialogue about aspects of the contracting arrangements. A full 'request for tender' (RFT) process was introduced from the second round of contracts.

Prior to adopting a prime contracting model, the HRA had contracts with more than 80 training and employment service providers delivering multiple programmes across the city. By early 2000, the HRA had moved to a prime contractor commissioning model, with 15 prime providers contracted to deliver a range of job placement and training and rehabilitation services.

Within a decade this number had almost halved, and there are now eight large prime providers in the welfare to work market, with limited market diversity. The use of sub-contractors is very much left to the primes and has decreased markedly since the new commissioning structure was first introduced. Sub-contracting is regarded as essential to the delivery of professional vocational rehabilitation services, but less so with regard to back to work services.

New York deliberately adopted a more hands-off, laissez-faire approach to market stewardship. While there has been an expectation that primes will choose to sub-contract services, there has been a relatively low level of sub-contracting, and much lower involvement among third sector organisations. This partly reflects the fact that, in contrast to the UK, diversity of supply providing choice for customers was not a policy aim of the New York reforms. This hands-off approach has impacted on third sector involvement in a number of ways:

First, the reduction in the number of primes over time has left fewer, larger organisations covering more areas. Smaller potential sub-contractors found it difficult to compete for large scale contracts requiring delivery across multiple sites.

The lack of third sector presence in the market also reflects payment structures, with payment milestones increasingly weighted towards long term outcomes such as retention in employment. Early contracting arrangements involved payments made according to the number of clients served and the specific processes undertaken with them, such as pre-employment assessments and job placements. However, the HRA has moved towards a commissioning approach which, since 1999, has become 100% outcomes-based payments with no process payments remaining.

This has helped reduce costs for the HRA and incentivised service providers to help the HRA achieve lower levels of welfare payments by focussing on keeping people in work. But this has come at the expense of customer choice and the involvement of niche specialist and third sector organisations, for whom the combination of upfront bid and operational costs combined with long-term payment milestones created cash flow problems and barriers to entry. This had had a knock-on effect on levels of innovation, which are perceived to have decreased. Prime-subcontractor relationships are also not regulated by a code of conduct.

Performance league tables are published which, along with outcomes-based pay, encourage competition in the market. However, there is less focus on promoting competition for the market, with evidence that market entry is not as open to new bidders as it is to incumbents who know the system well, and past performance playing a key role in the selection of successful bids. This, once again, reflects a greater concern with promoting efficient delivery than

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<sup>30</sup> This case study was prepared on the basis of interviews with members of a DWP-PwC study trip to New York to examine the effect of New York's welfare reforms. The results of that trip were published in Department for Work and Pensions Research Report No 614, which can be found here:

<http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep614.pdf>

competition and diversity, though, as one interviewee pointed out:

*“Competition for market entry is itself a spur to greater efficiency. In the long term there might need to be a shift in commissioners’ focus to reflect that.”*

Outcomes-based pay brings clarity and simplicity to performance monitoring and management, but it also brings particular challenges in the welfare to work arena, where, just as in the UK, forecasting demand has proved difficult with changing market conditions and different clients progressing through the system at different rates. This, again, is a particular challenge for smaller providers.

While the policy objectives in New York are different to those in the UK, the experience there highlights the enormous difference that decisions about the extent to steward and regulate the market can make to the diversity of the provider landscape, the level of competition and the type of service provided to the customer.

## Australia<sup>31</sup>

The Australian Job Network was established in 1998 by the Australian Department for Employment and Workplace Relations (DEWR). Centrelink, the Australian equivalent to JobCentre Plus, acted as the conduit to the Job Network, directing customers to regionally contracted suppliers.

In 1997, 306 organisations were selected from over 1000 bidding organisations. Over the course of the next decade this number had fallen to below 100, with the proportion of public sector suppliers falling from one-third to just three per cent.

The first wave of contracts was based on fixed prices for the most difficult cases, with a bid price for remaining services, and a combination of upfront and outcome payments. Tenders were assessed on a combination of quality and price and five suppliers were appointed to compete in each region.

Three significant changes were introduced during the second round of contracting. First, price competition was extended to the most difficult cases, with a minimum ‘floor price’ set by the Department (most successful bidders chose to bid at the minimum price). Second, a set of requirements were introduced for suppliers to outline the services they would provide for their customers, which would be monitored by contract managers. Third, a ‘star ratings’ system was

introduced, with a formula allowing a comparison of provider performance.

A combination of administrative burdens and uncertainty resulted in a widespread fall in performance during the re-bidding process period.

Allocation was based largely on performance in the first contracting period, with the (former) state suppliers (Employment National) losing 29% of their contract volume. Employment National operated under a ‘community service obligation’ intended to guarantee welfare to work services in remote areas which might not be commercially viable for independent suppliers. However, all regions did attract commercial interest. Employment National failed to win any contracts in the third contracting round and subsequently exited the market.

Employment National’s loss of market share in the second contracting period was redistributed evenly to the private and third sectors.

An OECD evaluation<sup>32</sup> four years into the programme found that it was performing as well as the previous system at much lower costs. However this evaluation did not take into account the significant transaction costs for all concerned. Evidence also emerged that suppliers were ‘parking’ the hardest customers, incentivised instead to collect up-front payments and then concentrate on those who were easiest to place back in work.

The response of DEWR was to adjust the weightings for outcome payments, increase the amount of specified services and introduce a Code of Service Guarantee to ensure all customers were receiving a high level of attention. They also introduced a mandatory IT system to exchange information with Centrelink.

In order to reduce the levels of disruption that had taken place during the second round of contracting, in the third round sixty percent of contracts – those above a specified score in their star ratings – were automatically renewed. The remaining contracts were let on a fixed price tender with bids decided on a mixture of proposed service delivery and previous track records.

With only 40% of the market opened up to competition and just seven new suppliers winning contracts, the total number of suppliers fell to 109. The transition was not totally smooth. Anticipating similar issues that subsequently arose with Flexible New Deal, there were problems with the new IT

<sup>31</sup> Published sources for this case study were Finn (2008) and DWP (2006). Telephone interviews were also conducted with a director of the PwC office in Melbourne, Australia and an official at the Department of Education, Employment and Workplace Relations in Australia.

<sup>32</sup> OECD (Organisation for Economic Co-operation and Development) (2001) ‘Innovations in Labour Market Policies: The Australian Way’.

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system and Centrelink overestimated future volumes. This caused a real threat to suppliers, forcing the Department to provide more advance payments. This experience contributed to DEWR awarding 95% of the next round of contracts to existing suppliers (deselecting those with the lowest star ratings), providing limited opportunities to new entrants.

Supplier's incentives to supply a good service were preserved by re-allocating market share based on twice-yearly performance evaluations (with upper and lower limits). Poor performers could have their contracts cancelled. In 2007 this threat was carried through, with almost ten per cent of contracts put out to market, with the majority won by existing Job Network members.

The existence of upper and lower limits to market share has been offered as one reason why suppliers did not market themselves better to consumers, with a knock-on negative effect on client choice, suggesting that the limits were perhaps set at too narrow a range.

The Australian approach has seen in diverse and innovative approaches by suppliers. However, there has also been evidence of 'gaming' in the system, such as putting different customers through the same job in order to secure outcomes payments.

As the Department has increased levels of regulation, there has been criticism from suppliers that early levels of flexibility have been diminished and the nature of the relationship between DEWR and its suppliers has undergone significant change towards a more top-down model.

After the third (and last) round of competition, the market share for third sector organisations grew to 50% (and accounted for 54% of Job Network members), with the largest two suppliers both being community organisations (Salvation Army and Mission Australia). However the increase in regulatory burdens and IT requirements meant that the growth in market share had come at the expense of consolidation towards larger community organisations, with smaller suppliers exiting the market and, according to some, a loss in community 'ethos' in those organisations that remain in the market.

This is consistent with the expectations of most interviewees in the FND case study, with expectations of some consolidation in the market over coming years.

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## *E. Findings*

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## The importance of public sector commissioning

Public sector procurement of goods and services is of utmost importance to the UK economy. The public sector procures approximately £220 billion of goods and services each year, which comprises around one third of all Exchequer expenditure and, frequently constitutes a large percentage of a given supply market.<sup>33</sup> Indeed in some markets, such as health, education, justice and transport, the public sector is often the main purchaser of products from suppliers. In total, services commissioned by the public sector account for 6% of GDP and around 1.2m jobs.

Public sector procurement ultimately aims to achieve the best possible value for money for the tax payer. However, that aim can manifest itself in several different ways: focusing on price or quality in the short-term, focusing on stimulating the development of a market, for example through innovation to generate longer-term value, or considering wider factors such as the impact of procurement on economic growth.

Equally the macroeconomic effects of public sector commissioning are also important due to the size of the public sector and its potential impact on a supplier's domestic and international capabilities and reputations. Here there is also evidence that there can be a trade-off between different objectives faced by public sector commissioners, which can lead commissioning to be detrimental to longer-term value and economic growth.

Clearly in the current fiscal climate, an area of spend where a 10% cut in price would generate £22bn of exchequer savings is very important. Indeed there is evidence (for example, in the Green Review) that the public sector does not consistently achieve the best value for money when it procures goods and services from the independent sector.

Since the 1980s there has been a long-term trend for government to procure the delivery of public services from the independent sector. This can be seen, for example, in the increasing use of private and voluntary organisations in the provision of welfare to work services, in the outsourcing of prisons and in the increasing use of private accommodation in the adult social care market.

While the government still spends more in aggregate on the provision of in-house services than it buys from other suppliers in the private and third sectors, it has been announced that the coalition government sees an increased role for the independent sector as vital to

achieving its aims for the public services and as a key element to its Big Society agenda.

### Approach

The OFT commissioned PwC to undertake economic research into public sector commissioning. The purpose of this research was to:

- Gather evidence, on behalf of the OFT, on the impact of public sector commissioning and procurement on competition and markets; and
- Assist the OFT identify practical insights that can be used by public sector commissioners and procurers on how best to promote and sustain effective competition, and thereby create dynamic, open and contestable public services markets in which commissioners, procurers and suppliers alike face appropriate, aligned incentives to achieve and sustain value for money

This report serves to provide an evidence base to the work undertaken by the OFT in examining public sector commissioning and competition in public services markets, and aims to support their wider advocacy work aimed at promoting and raising awareness of competition issues in government.

PwC's approach to carrying out this research involved:

- a review of the academic literature;
- an in depth analysis of six case studies; and
- 30 further interviews people involved in commissioning and procurement in government markets.

It should be noted that this study, whilst providing useful insight, is not comprehensive and that findings - including those gained from the stakeholder interviews - are qualitative rather than statistically significant.

## Findings: Behavioural Drivers of Commissioning

In chapter C we identified seven drivers of commissioning behaviour which can be grouped according to the entity affected. This is depicted below.

We used this model throughout our research in order to structure our investigations and to collect and sort our findings; these are discussed in turn below.

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<sup>33</sup> Public Expenditure Statistical Analyses 2009, HM Treasury (2009)

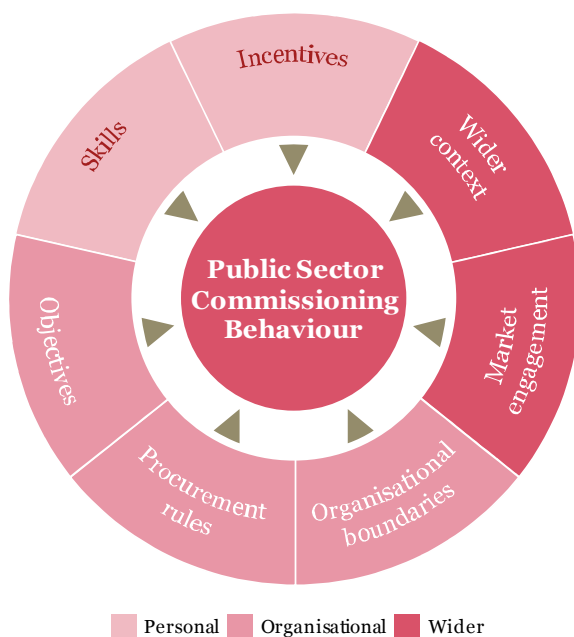


Figure 20 Drivers of public sector commissioning behaviour

## 1. Incentives

### Findings

Throughout our case studies and interviews we found a strong public service ethos amongst commissioners and procurers and a clear focus on securing value for money for the taxpayer. We also found evidence that individuals working in procurement and commissioning are highly responsive to the incentives presented by the regimes they operate in. This should be no surprise as there is good evidence that the behaviour of people working in public service is affected by such incentives.

Our evidence from the case studies points to some lack of alignment between public sector objectives and individuals' incentives. This appears to lead to commissioners and procurers focussing more on some aspects of deals (for example, design and build in the short term) than others, which may actually be at least as important (operate in the longer term). Our evidence points to this being a particular concern on longer-term contracts where goods and services are bundled together and where there is organisational separation between consumer and procurer.

We also found evidence that public service buyers are more risk averse than might be desirable.

### Illustrations

- In prisons, there was a perception that procurers were incentivised by the prospect of promotion to focus on the short term, for example by getting a deal signed and a new building constructed.

- In residential care, there was evidence that buyers were not incentivised to think about the impact on value for money for the wider public sector
- In schools procurement, there was evidence of local authority staff not using Public Sector Buying Organisations' contracts because they were worried about losing their own buying functions

### Key point

People involved in procurement and commissioning in the public sector respond to incentives. The alignment of their incentives to the public sector's objectives, including those of enhancing the growth prospects of the UK economy, is important.

## 2. Skills

### Findings

We found consistent evidence that people involved in procurement do not always possess a sufficiently high level of skills. For example, participants reported that procurement teams used staff who were too junior to undertake important tasks and lacked contract management skills; they also suffered from high staff turnover. There was also evidence that procurers did not have sufficient understanding of the impact of their own actions on the relevant markets.

As a result there was evidence to suggest that as a result of the skills gap the public sector frequently failed to counteract suppliers' market power resulting in inefficiencies in the market.

### Illustrations

- The prison procurement directorate was characterised by suppliers as having high turnover amongst staff resulting in a lack of institutional memory.
- In social care there was evidence that commissioners did not understand how their commissioning decisions impacted on the finances of other government departments.
- In hospital facilities management the combination of contract bundling, and a focus on the design and build phases of a hospital meant that many organisations did not have the necessary skills and experience to manage contracts once a facility had been delivered.

### Key point

There may be gaps in the skills of procurement people in public sector organisations. Addressing these gaps could improve outcomes.

### 3. Objectives

#### Findings

When procuring goods and services, the public sector tends to have a wider range of objectives than a private sector counterpart. The public sector clearly aims to achieve value for money for the taxpayer– this applies to both the short and long-term, taking into account both price and quality.

In some markets, particularly where quality is difficult to assess and the government is a major buyer, there can be tensions between objectives. For example, driving a hard bargain in the short-term may subsequently inhibit investment and innovation, undermining the creation of longer-term value.

There are examples of commissioners carefully thinking about these trade-offs and, for example, focussing on the long-term development of supplier markets. However, our research suggests that in many cases commissioners and procurers did not often give sufficient consideration to these trade-offs.

In some cases procurers may be very focussed on short-term price to the detriment of quality, longer-term value and economic growth. In other cases buyers appear to be very price-insensitive and instead be more focussed on particular aspects of ‘quality’, for example being comfortable with the people they are dealing with. We also found examples where the commissioners’ relative weighting of objectives changed over time, causing cycles in markets that proved to be destabilising for producers. However, in other cases, there appeared to be substantially more focus on longer-term market development.

In the case of competitive dialogue, we found that some procurers were starting the formal process too early, without conducting sufficient research to clarify their objectives beforehand.

#### Illustrations:

- In adult social care our evidence pointed to an overwhelming focus on short-term price, which tended to drive down quality. Occasionally the priority then switched to quality for a short period, to address ‘political’ and other pressures resulting in instability for suppliers including market entrants.
- In school procurement a desire for more local accountability as many acknowledged conflicts with the objective of centralising procurement to achieve economies of scale.

#### Key point

Commissioners and procurers do not always consider the relative importance of different objectives with sufficient clarity; therefore commissioning strategy is not always conducted on the basis of a clear set of objectives.

There is not a single ‘right answer’ to the appropriate trade-off between the public sector’s different commissioning objectives. In the current climate, an excessive focus on short-term price, particularly in some markets, may be detrimental to achieving longer-term value for taxpayers and the wider economy.

### 4. Procurement rules

#### Findings

Public sector organisations must adhere to EU procurement rules. We found evidence that in some instances an excessively prescriptive interpretation is placed on these rules. This may lead to an overly bureaucratic process, a lack of constructive engagement with potential suppliers and excessive costs which can put off some potential market participants (particularly SMEs).

The interpretation of procurement regulations is often made by the organisation that procurers work for and staff may not feel that they have the ability to adapt the approach taken to suit the specific circumstances, particularly if staff are quite junior or new to the organisation.

However, a small number of respondents suggested that procurement rules are a lot less prescriptive than many people think. In some instances there was evidence that these potential problems were avoided with apparent success.

#### • Illustration:

In the prisons sector suppliers suggested that they tended to write bid documents to conform to the rules of the process rather than in ways that highlighted the innovation they could bring to the sector.

#### Key point

Public sector organisations do not always design the best procurement process for the task. EU rules seem to often be interpreted in a highly prescriptive way. This can lead to perceived restrictions driving procurement activity, rather than the process being driven by the procurement objectives.

## 5. Organisational Boundaries

### Findings

We found consistent evidence that organisational and professional boundaries within the public sector reduce the effectiveness of the procurement process.

In particular, we found evidence of barriers within public sector bodies between people responsible for policy/strategy development, specification, commissioning strategy and operational procurement. These barriers can lead to the actions of procurement people who are responsible for evaluating and managing suppliers being very different to that which might be desired by strategy and policy-makers. This can result in outcomes different to those envisaged by policy makers or the elimination of potentially good suppliers at an early stage of the evaluation process.

There is an interesting symmetry between this finding and the insight from the PADA case study about the importance of dealing with the person that will be responsible for delivering and implementing the service, rather than just the sales team. In ideal circumstances, the people on the buying side who understand what is being brought deal with the people on the supplier side who have a stake in delivery. In non-ideal circumstances, people who lack rich insights into what is being bought deal with those who will have limited involvement with delivery. Our evidence suggests that many procurement exercises operate somewhere between these two worlds.

Equally there was a reported lack of engagement and communication between the people involved, who are often from quite different professional backgrounds, in different parts of the organisational hierarchy and of different 'status' in the organisation.

### Illustrations

- The procurement of hospital facilities management is often undertaken as part of the procurement of a new hospital facility. As a result there is a significant mismatch between the objectives of the initial procurement team who will be focused on securing the best facility and the objectives of the long term customer who will need to operate the building efficiently.
- In the example of schools procurement there is considerable fragmentation of demand without clear rationale. As a result it is difficult for suppliers to target specific buyers in order to grow market presence.

### Key point

There can be barriers and a lack of alignment between different people involved in commissioning and procurement within public sector organisations. There may be room to improve performance by doing more to build engagement and agree objectives between the people involved.

## 6. Market Engagement

### Findings

We found evidence in a number of areas that those involved in public service commissioning and procurement do not always engage fully or constructively with potential suppliers.

We found evidence of commissioners and procurers not having a good enough understanding of relevant markets. We also found that both commissioners and procurers appeared to not fully understand the impact of signals they sent to suppliers. For example in a number of the cases we looked at, the public sector had cancelled procurements at a late stage or ended contracts early. This had the effect of creating significant uncertainty in the market.

Whilst this type of action may well be required from time to time because of a changing political or economic environment, it was not clear that those involved understood the impact on suppliers, who clearly took this information into account when considering whether and how to participate in markets. It is likely that such behaviour increases cost and risk to suppliers, therefore increasing costs to buyers, reducing the vibrancy of competition and often reducing incentives to innovate.

Market engagement involves engaging directly with suppliers and gathering accurate information. We found that a lack of information was a challenge for commissioners and procurers in a number of markets.

In the private sector, there are examples of industries collaborating to support information systems that offer supplier information across an entire industry.<sup>34</sup>

Evidence from the care homes market suggests that in the absence of effective market engagement, commissioning behaviours can be informed by mistaken perceptions of suppliers' capacity, views and motivations.

### Illustrations:

- In the prison sector suppliers have not always had sufficient clarity over the direction of private sector involvement in the market and suffered from the

<sup>34</sup> 'Procurement under the spotlight', Times, 10 March 2011

late cancellation of individual projects after bids had been submitted

- In social care suppliers we spoke to complained about a lack of clear strategic direction from local authorities, resulting in market inefficiencies and difficulties in planning
- In the flexible new deal procurement, DWP outlined strict engagement behaviours it expected from suppliers, however it offered no commitment as to its own processes which led to reported uncertainty amongst suppliers
- In hospital facilities management, a lack of high quality comparable data is limiting the effectiveness of benchmarking exercises.

#### **Key point**

Commissioners/procurers could often benefit from more engagement with and understanding of potential suppliers. They could also spend more time assessing the impact of any signals they send to the market.

### **7. Wider Context**

The current state of the economy and the fiscal position is having a major impact throughout government, with an increased focus on price across a range of different markets. In some cases this is accompanied by a very short term focus. Both of these have the potential to work to the detriment of long term competition and suppliers' incentives to invest and innovate.

More generally, the impact of wider government policies and initiatives varies. In some markets, such as residential care home places and welfare to work services - payment by results, a greater role for SMEs and third sector organisations, personalisation, and localism are having a major effect on the shape of the market and the challenges and opportunities faced by suppliers. The personalisation agenda in social care is resulting in personal budgets for consumers. These can allow the care home operators to engage directly with the consumer; however uncertainty about how budgets will be calculated makes business planning difficult for suppliers and potentially undermines consumer choice. While many of these initiatives have been welcomed by suppliers, the impact on competition often depends upon careful implementation to avoid unintended effects.

#### **Key point**

Suppliers sometimes perceive tensions between different Government policy aims. It is helpful for Government to articulate how they fit together to avoid unintended consequences.

## **Findings: Other key issues**

In addition to the seven behavioural drivers of commissioning activity, a number of other issues arose from our research. In many cases they were the result of more than one behavioural driver.

### **8. Bundling**

#### **Findings**

The decision to bundle a range of required products and services into one big contract, or to break up requirements into several distinct procurements is an important feature of many big government commissioning exercises.

In the right circumstances, bundling can bring significant benefits, reducing the number of contracts to manage and, in the case of PFI, incentivising those designing and building the facility to ensure it is easy to maintain and supports the desired operating model.

In several cases though, we found evidence that commissioners/procurers had bundled too many different services into one contract. There was also evidence that buyers were not focussed sufficiently on all elements of the contract during the procurement process. For example, paying inadequate attention to certifying the longer term 'operate elements' of a design, build, operate contract.

This appears to lead to a tendency to go to market in a way that:

- Suits the few largest suppliers because of the scale and mix of services required;
- May not access the right suppliers, for example because specialists are put off by inclusion of services outside their core competence; and
- Has more focus on design and build, and less on operate, driving up long-term maintenance costs.

We did not find evidence that there is a general 'right answer' to the decision over bundling. The best decision will depend on a range of factors that will vary, including the nature of the services required, the structure of the relevant market(s), the nature of integration risk, investment required etc. However, there was limited evidence that this decision was given much consideration in some important instances. In others, it was central to the approach and the bundling decision really drove the procurement.

#### **Illustrations:**

- PADA started off with an assumption that it would bundle all of the services it needed in one contract and began engaging with the large systems integrator market. However, on carefully

considering how best to bundle its services, it changed its approach and focussed on a more narrowly defined (though still large) pensions administration contract. As a result it engaged with large pension administrators globally.

**Key point**

Commissioners and procurers do not always recognise the decision over whether and how to bundle goods and services together when procuring as one of the most important in the commissioning cycle. In fact, the bundling decision can drive many key aspects of procurement, such as choice of suppliers.

**9. Payment by results**

**Findings**

A number of the people we spoke to believe greater use of payment by results will improve the value for money achieved by the public sector and will create greater innovation in the supply of services.

However, some concerns were expressed about the impact payment by results might have on SME and voluntary sector suppliers. This is because they often find it more difficult to meet the cash-flow challenges inherent in asking suppliers to bear costs well in advance of achieving the outcomes which result in their being paid.

We also noted a range of approaches being taken to the funding challenge created by use of payment by results in different parts of the public sector. For example, social impact bonds have been used to fund probation services whilst in welfare to work prime suppliers have been asked to find the upfront funding.

**Key point**

Payment by results has many advantages but does create significant funding challenges for suppliers, particularly SMEs and voluntary organisations.

**10. Entry**

The general trend in the public sector is away from supplying services itself and towards the commissioning of services from third parties. This has had a significant impact in some markets, such as social care.

However, we note that there appear to be significant barriers to private and voluntary suppliers accessing some markets as self-supply still dominates in areas of the public sector.

Where markets had been opened up to competition, we found evidence of a bias towards self-supply i.e. a

lack of competitive neutrality<sup>35</sup>. One example given was a view that comparison of the cost of public and private provision was not a fair one because a significant part of the costs of public service pensions are excluded from public sector costs. We would note that our research focussed on areas in which commissioning has happened – there are several areas of the public sector where it has not happened in a significant way and self-supply bias may be greater.

We also found consistent views among suppliers and others that public sector procurement activity can create unnecessary costs, for example because procurement processes were unnecessarily bureaucratic. There was a perception that provider risks were higher than necessary, for example because investment in procurements or frameworks might not lead to any work, or because contracts might be ended early. These factors are likely to affect suppliers' decisions over whether and how to participate in public service markets, at the expense of vibrancy of competition and value for money to taxpayers.

A further entry to barrier is formed by the uncertainty that electoral cycles bring, with the effect of raising bidding costs for potential suppliers, as with PADA, where this impacted on decisions or potential suppliers decision about whether to bid, and the prisons case study, where the decision not to award a contract after a lengthy bidding process sent mixed signals to the market. With FND too, the redesign of the welfare to work system meant a change to the business plans of a large number of often small organisations. While electoral uncertainty is difficult to avoid, the increases to bidding costs during this period should be acknowledged.

**Illustrations:**

- In the prison sector no public sector operated prison has been taken over by a private provider. There was a view that, in the past, cost comparisons made by across the public sector when considering outsourcing provision underestimated the cost of public sector benefits including pensions.
- Even in FND, where DWP actively sought to stimulate the supply side of the welfare to work market, there was a view that they had been less successful than they had hoped in attracting new suppliers due to the terms of the potential contracts.

<sup>35</sup> See the OFT's report, 'Competition in mixed markets: ensuring competitive neutrality' for a fuller discussion of the importance of competitive neutrality.

### **Key point**

There are still significant barriers to suppliers entering many public sector markets. Value for money for taxpayers may be improved if commissioners can identify and remove these barriers.

- The Personal Accounts Delivery Authority gave a significant weighting in the procurement process to the details of the ending of its contract. This however was seen as the exception rather than the rule

## **11. Exit**

### **Findings**

We found some evidence of public sector buyers giving consideration to the retendering of contracts and how to prevent incumbency from developing. There was also more limited evidence of provision being made for the possibility of supplier failure. However, in general there was little evidence that these questions were explicitly addressed.

Knowing that exit is a possibility is important for creating the right incentives on suppliers to bid realistically and to maintain a high level of service, as we found in the Flexible New Deal case study.

Where exit was considered it tends to be considered as a constraint on independent sector involvement due to the risks presented to service continuity. This does not always have to be the case as coping mechanisms such as financial bonds or “supplier of last resort” procedures have been developed in some sectors. This is where a regulator or market maker has powers to require another provider to take over the activities of a failed provider. Such a scheme exists in consumer energy - if an energy distribution company were to fail, OFGEM would have the powers to take all the assets associated with their consumer business and all the customers accounts and to force all other suppliers to bid for that company’s business in a 24 hour competition. OFGEM would then decide which provider or providers must take on the business. The bid prices can be negative. In this case OFGEM pays the new supplier to take on the failed provider’s customers – for example, if the billing records are in a bad state or if they have “poor” customers. The costs of such a subsidy are then levied on all other consumer suppliers.

In the current economic climate, exit – either voluntarily or through failure – is a particular concern, for example in areas such as the market for residential care homes. Failure in particular is likely to become even more important as immature markets in health, welfare to work and other areas continue to develop.

### **Illustrations:**

- There has been a gradual withdrawal from the provision of adult social care and a shift towards personal choice and budgets on the commissioning side, however this presents new challenges for local authorities in the event of a provider failure that as yet have no formal solution

### **Key point**

The exit of suppliers, either through their own failure or choice, is an important consideration that is not always a feature of procurements.

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## *F. Appendices*

# Appendix 1

## Literature review

### Introduction and purpose

The public sector procures approximately £220 billion of goods and services each year, which comprises around one third of all Exchequer expenditure or 15% of UK GDP. As a result there has been a great deal written over the past decade, from a range of sources including academic centres, government and independent experts, on the impact of government commissioning and procurement activities on competition and competitiveness of the UK economy as a whole.

This body of literature provides an important background for our report as it provides theories, evidence, and context, upon which we can build the analytical framework for our research into the impact public sector commissioning can have on competition and competitiveness.

The rest of this appendix summarises the literature provided by these two fields of research. In undertaking this endeavour our task was not to enter into the academic debate set out by the literature, rather it was to set the direction for our research framework. As a result what follows is a summary of the body of evidence focusing on the academic research in to the potential and evidential effects of commissioning on competition.

### Factors affecting the degree of competition in a given market

In 1979 Michael Porter developed a framework for industry analysis and business strategy development. This framework “the five forces analysis” is designed to help organizations determine the competitive intensity and therefore attractiveness of a market. Attractiveness in Porter’s context refers to the overall industry profitability. An “unattractive” industry is one in which the combination of these five forces acts to drive down overall profitability. A very unattractive industry would be one approaching “pure competition”, in which available profits for all firms are driven down to zero.

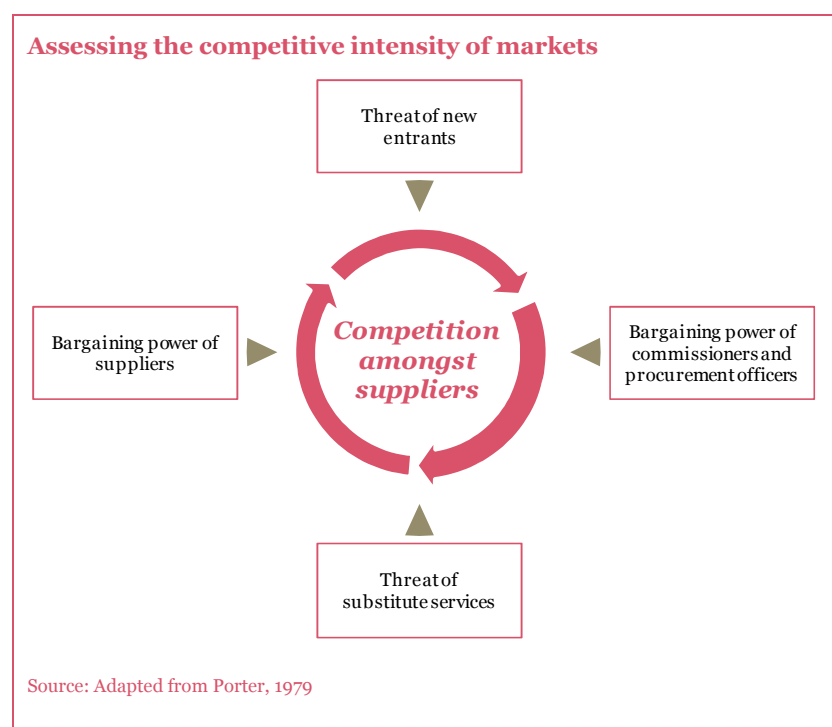


Fig 21. Assessing the competitive intensity of markets

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While Porter's framework is principally designed in order for organisations to determine the attractiveness of investment decisions, it can also prove useful in reverse for organisations such as national or sectoral regulators when determining the degree of competition in a given market.

From this perspective the framework notes that the drivers of effective competition go beyond established industry rivals to include four other competitive forces as well: customers, suppliers, potential entrants, and substitute markets. The extended rivalry that results from all five forces defines an industry's structure and shapes the nature of competitive interaction within an industry.

Here we depict an adapted version of Porter's five forces framework and discuss each force in turn.

### **Competitive rivalry amongst existing suppliers**

Traditional competition analysis tends to look at the degree of competition between firms for the market, where there is a significant level of competition. In this context, economic theory suggests that consumers will receive a competitive good or service and suppliers will be likely to innovate and gain advantages in other related markets.

Traditional analysis suggests that the level of competition between suppliers depends on the relevant range of dimensions, e.g. price, quality, value within the procurement exercise and the importance attached to each. It is also affected by the degree to which suppliers and commissioners take a short term or long term view. Alternatively competitive rivalry may be undermined by the threat of collusion and as such there is a substantial role for transparency in the commissioning process in order to avert such behaviour.

### **Bargaining power of suppliers**

While competitive rivalry may be strong during the procurement phase, if suppliers hold significant bargaining power over commissioners in this process (or once contracts have been agreed), there is potential for the outcomes from the procurement and contracting phase to become suboptimal.

Supplier bargaining power increases where the supplier holds large market share (or even a monopoly) and/or the supplier is of strategic importance to those demanding goods and services. This may occur where there is contract aggregation or when other agendas (e.g. localism, environmental or risk) shift the definition of 'the market' and reduce the number of potential suppliers. It may also be enhanced where suppliers have multiple revenue streams or where commissioners face high switching costs, as can often be the case in the public sector due to the expectations and circumstances of service users.

### **Threat of entry**

The threat of supplier entry to the market can put a cap on the profit potential of an industry, provide a limit to the bargaining power of suppliers and create dynamism amongst existing suppliers. When the threat is high, incumbents must hold down their prices or boost investment in their services to deter new competitors.

Barriers to entry such as participation restrictions, contract aggregation, and information asymmetry can all reduce the threat of entry and in turn competition amongst suppliers.

### **Bargaining power of commissioners and procurement officers**

In economics, monopsony is a market structure in which sellers face a single or a small number of buyers. The presence of such a market creates similar concerns as does the presence of monopoly, in which only one seller faces many buyers. As the only purchaser of a good or service, the "monopsonist" may dictate terms to its suppliers in the same manner that a monopolist controls the market for its buyers, which can result in sub optimal outcomes for the system and a lack of scope for suppliers to innovate and effectively compete.

Monopsonistic markets can emerge in scenarios where commissioners and procurement offices have significant bargaining power. Commissioner bargaining power increases where the commissioner has a large market share, where the commissioner's demand is of strategic importance to suppliers, where there is a lack of information on commissioners' demands or budgets or where there is the potential to self supply.

### **Threat of substitute markets**

In a similar way, as the threat of market entry creates a limit to provider side market power the threat of potential substitute markets for suppliers helps to constrain commissioner buyer power as it allows suppliers to withdraw to other markets rather than face the demands of the monopsonistic commissioners.

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The threat of substitute markets becomes less credible where there are high switching costs or where services demanded address a unique set of end-user requirements/policy objectives. In the public sector the threat of substitute markets can be constrained as in some markets or subsections of markets (e.g. defence or health) the public sector can often be the sole purchaser in the sector. In other markets however the public sector suppliers can have a number of alternative related markets (e.g. suppliers of residential care in coastal resorts can often enter the B&B market). An area in which Porter's model has been developed is in analysis of markets for compliments, although this is generally less important for the purpose at hand.

## Impact of commissioner and procurement officer behaviour on competition and competitiveness

In 2005 the Office for Fair Trading commissioned .Econ to produce a summary of the academic literature on the economic effects of public sector procurement on competition and competitiveness. This report entitled 'Assessing the impact of public sector procurement on competition<sup>36</sup>' provides two important inputs to our research methodology. First, it provides a useful working definition of both 'commissioning' and 'procurement', and second it outlines three potential ways in which government commissioning and procurement can result in suboptimal outcomes. These two inputs help provide structure to the remainder of this literature review.

### Definitions of "commissioning" and "procurement"

As detailed in the .Econ report, while there are no standard definitions, the following broad descriptions serve as a useful starting point for understanding the terms:

- 'Commissioning' is the cycle of assessing the needs of people in an area, designing and then achieving appropriate outcomes;
- 'Procurement' is the actual purchase of goods and services by budget holders.

### Ways in which government commissioning and procurement can result in suboptimal outcomes

The .Econ report concludes that there are three ways in which government and public sector commissioning and procurement can result in suboptimal outcomes

1. Failure of commissioners and procurement offices to exercise buyer power due to the presence of:
  - a. Fragmented demand (often due to a desire to promote localism);
  - b. Uncompetitive suppliers;
  - c. Self supply; and
  - d. External pressures (e.g. environmental concerns, pressures to support SMEs or requirement to protect data).
2. Restrictions on competition due to poor commissioning and procurement behaviours including:
  - a. Participation restrictions;
  - b. Contract aggregation (bundling);
  - c. A lack of transparency; and
  - d. Risk aversion.
3. Excessive or poorly focused competition within the market as a result of:
  - a. The design of the procurement process; and
  - b. Frequent competition for small contracts similar in nature.

Over the next few pages we use the structure and the definitions set out above to discuss the literature relating to the impact of public sector spending decisions on competition and competitiveness. We find that a number of areas including failure to exercise buyer power due to fragmented demand have received substantial attention in both the academic and mainstream media.

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<sup>36</sup> Office of Fair Trading (2004), 'Assessing the impact of public sector procurement on competition'

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In other instances, such as failures to compete due to historical self supply, we find that the literature and research is much less extensive. This finding has helped us to target key areas of government procurement and commissioning for our research and as helped us to identify case studies and lines of enquiry throughout the research.

## Failure of commissioners and procurement offices to exercise buyer power

### Fragmented demand

The .Econ paper notes that buyer power can be exercised by bargaining for lower prices, especially useful where there is market power amongst suppliers<sup>37</sup>. By using buyer power, commissioners can achieve reductions in the price paid to monopolistic suppliers towards the efficient level and the cost of public services for taxpayers.

Whilst such buyer power increases with the relative size of public sector demand, it is often substantially reduced by fragmented and uncoordinated public procurement in certain sectors. This has been the source of substantial commentary following the emergence of the fiscal crisis. In particular, Phillip Green's 'The Efficiency Review' criticises the frequent lack of coordination in public procurement, which undermines the ability of the public sector to operate as a single buyer with great buying power and economies of scale.

Although the study draws on information on commodity procurement, property and major contracts, the implications are pertinent also to services, where the overarching issue of fragmented demand persists. In particular, the Green Review provides numerous examples of the Government failing to exercise the advantages of its scale and credit rating.

Fixed line telecommunications is highlighted by the Green Review as the clearest instance of the Government's failure to leverage its scale. The study estimates that such costs amount to £2bn per year, with departments purchasing telecoms separately from various suppliers. The study suggests it could be 30-40% cheaper for the Government to buy its own capacity.

The report suggests that the underlying drivers of such fragmentation are unreliable or unavailable data, the nature of Government as a series of independent departments, the lack of incentives to save money, the lack of a process by which department budgets can be challenged, inconsistent commercial skills across departments, and the lack of any clear political mandate in favour of more centralised procurement.

The finding of great variation in prices paid across the public sector is supported by a review by John Neilson of the NHS Shared Business Services (NHS SBS), the body responsible for achieving best value for money through outsourcing NHS administrative functions such as finance, accounting and payroll. This review finds around 12% of the NHS purchasing budget is lost each year to inefficient differences in prices paid for services, and could be saved if health managers worked together to standardise equipment and exploit the bulk buying power of the NHS.

### Collaborative procurement

Collaborative procurement is the process by which such fragmented procurement can be adapted to incorporate greater coordination between Government departments and achieve substantial savings. The Green Review provides the example of collaborative procurement in energy, which through purchasing 75% of gas and electricity through a centralised expert team delivered cumulative efficiency savings of £500m over the last 4 years.

The Institute of Directors (IOD) paper 'Towards Tesco – Improving Public Sector Procurement' notes collaborative procurement between independent bodies arguably represents under 10 per cent of total public sector procurement spending and its impact is blunted by the lack of a formal supporting structure, good quality data and political commitment<sup>38</sup>. The paper notes a general lack of understanding throughout the policy chain regarding factors that influence the cost of procurement, the cost, service and quality implications of 'unique' specifications, the benefits of category management and costs of geographically local procurement.

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<sup>37</sup> OECD (2008) Policy Roundtable: Monopsony and Buyer Power

<sup>38</sup> Towards Tesco – Improving Public Sector Procurement Colin Cram, Institute of Directors (2009)

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A recent paper by the National Audit Office (NAO), ‘A Review of Collaborative Procurement across the Public Sector’ notes that through collaborative procurement, government and the public sector should be able to achieve lower prices either by exploiting economies of scale, or from using pricing information to challenge suppliers on unit costs.

### **Self supply**

In many instances the benefits of competition between private and third sector organisations for public sector contracts may be disabled entirely by the public sector choosing to produce the goods or (more frequently) the services it requires. This act termed ‘self-supply’ serves to reduce the size of the market, the suppliers that the market can sustain, and in turn the competition in the market.

A large body of academic research refers to the productivity gap between the public and private sector. The Office for National Statistics reports that public sector productivity fell by 3.4% in the 10 years from 1997 – compared with a rise of 28% in the private sector over the same period.<sup>39</sup> Self supply is then relevant since it may sustain lower productivity; the role of competitive markets in driving lower prices, better quality and higher value is undermined.

While mostly seen as a barrier to competitive outcomes, in some cases self-supply can be an effective means of preventing tacit collusion by providing a credible fallback option in the face of inflated bid prices, as well as providing an internal benchmark for prices.

The .Econ paper notes in making the decision to self supply or procure, a current lack of competition or potential suppliers may bias decisions in favour of in-house provision, as decision makers fail to perceive that market competitiveness may improve significantly in response to realised public sector demand and results in lower prices.

### **Public sector outsourcing**

Public sector outsourcing, the transfer of services that were previously provided by the government to the private sector, is the opposing trend to self supply. According to the Institute of Directors (IOD), “outsourcing can bring similar benefits to shared services, with the added bonus of investment in new systems, greater attention to costs, a tighter performance regime, regeneration and sharing some of the risk”<sup>40</sup>.

Dr. DeAnne Julius’ 2008 Review<sup>41</sup> of public sector outsourcing found that the Public Service Industry (PSI)—that is ‘all private and third sector enterprises that provide services to the public on behalf of Government or to the Government itself’—accounted for 6% of UK GDP. The largest sectors for PSI spending were Health (£24.2 bn), Social Protection (£17.9 bn), Defence (£10.1 bn) and Education (£7.3 bn). The Review noted that “the growth rate of the PSI has been slowing and the costs of bidding are rising with an increasingly complex commissioning process”. The IOD comments that rising bid costs may lead to increase prices, discourage market entry and reduce incentives for innovation.

### **External pressures (e.g. localism, risk and preference for SMEs)**

In many public sector commissioning and procurement exercises, pressures that are external to the individual commissioners preference set, such as a preference for localism, a concern for the role of SMEs or a desire to promote environmentally friendly suppliers can enter the decision making process and constrain the competition possibilities. The recent NAO review<sup>42</sup> notes that as a result of these pressures, collaborative procurement may be constrained, with national, regional or local approaches to procurement being favoured. The exact nature of these constraints may introduce uncertainty as to the optimal procurement strategy to be used by procurement officers and commissioners and in turn impact upon competition amongst suppliers.

The current policy theme of the “Big Society” (discussed below), with its emphasis on localism and decentralisation of political decision-making may have important impacts on the form and reach of local constraints, and in turn on the type and extent of collaborative procurement.

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<sup>39</sup> Public sector pay races ahead in recession Robert Watts, The Sunday Times (2010)

<sup>40</sup> Towards Tesco – Improving Public Sector Procurement Colin Cram, Institute of Directors (2009)

<sup>41</sup> Public Services Industry Review - Understanding the Public Services Industry: How big, how good, where next? Dr Deanne Julius, Department for Business, Enterprise and Regulatory Reform (2008)

<sup>42</sup> A Review of Collaborative Procurement across the Public Sector National Audit Office (NAO) (2010)

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In addition to the localism agenda, there is a growing emphasis on the role of small and medium-sized enterprises (SMEs) as suppliers in public sector procurement. The Coalition's statement on 'Business' includes the aspiration that 25% of government contracts should be awarded to small and medium-sized businesses<sup>43</sup>. The OGC, in 'Small Supplier, Better value', have argued such enterprises offer benefits in terms of quality of service, innovation and value for money<sup>44</sup>. However, they also raise concerns about the ability for SMEs to effectively compete: "particularly in capital intensive sectors and sectors where Government procures very large volumes of common goods and services (for example utilities), large firms may be able to achieve economies of scale that enable products and services to be offered at a price lower than would be viable for a smaller firm".

In targeting these objectives, the OGC emphasises the need for a 'level playing field'; government procurement practices should be designed to increase transparency and reduce barriers to entry for smaller firms<sup>45</sup>.

## Restrictions on competition due to commissioning and procurement behaviours

### Restrictions on participation

In general the more bidders make for more intense competition, resulting in lower prices and better quality. Even though the incremental benefits from having more participants in a tender may become smaller as the number of bidders increases, in most circumstances adding bidders increases the level of competition. This suggests that any feature of public procurement processes that limits participation has a detrimental impact on competition.

In some cases there may be good reasons for limiting participation. These include situations where the buyer's needs are complex and requirements cannot be specified in a simple way, or circumstances where increasing the number of bidders can lead to higher prices because everyone bids more cautiously. This is the case where bidders are concerned about the risk of winner's curse.

These aside there are a number of behaviours identified in the literature that can result in sub-optimal restrictions on competition, these include:

- Contract aggregation (bundling);
- Long time horizons;
- A lack of transparency; and
- Risk aversion.

### Contract aggregation (bundling)

Through aggregating or "bundling" a set of requirements into a single procurement, the public sector may also affect competition and the outcomes it obtains from the process. While in sum the competition effects of contract aggregation are ambiguous, it may have a negative impact on competition; directly, by excluding smaller firms who are unable to meet all of the requirements bundled together, and indirectly, by reducing the chances of winning a contract.

In addition contract aggregation reduces the scope for yardstick competition, comparing the performance of different contractors providing similar requirements, or for in-contract competition where demand may be moved between contractors at the margin, or where a contractor may take over if another fails to perform.

### A lack of transparency

As an OECD roundtable paper<sup>46</sup> and the .Econ report suggest, increased price transparency will benefit buyers unless it results in considerably increased risks of collusion amongst sellers. The level and type of transparency in

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<sup>43</sup> The Coalition: our programme for government Cabinet Office (2010)

<sup>44</sup> *Smaller Supplier – Better Value?* Office of Government Commerce (OGC), (2005)

<sup>45</sup> *Small and Medium Sized Enterprises* Office of Government Commerce (OGC), (2008)

<sup>46</sup> 'Policy Roundtable: Price Transparency', OECD (2001)

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public procurement, and the means by which it is achieved is therefore an important economic determinant in considering the overall competitive landscape.

The positive impacts of transparency relate to greater accountability, fairness and reduced incentives for corruption in procurement practices. Competing suppliers are more aware of the characteristics of successful bids, increasing knowledge of the Government's requirements, and encouraging market entry of more efficient suppliers and exit of inefficient incumbents.

However, transparency can increase risks of collusion since cheating is more easily detected and punished in bid rigging. The types of price transparency measures that are more likely to be anti-competitive are those that involve gathering price information for centralised publication.

The OECD comments that collusive behaviour is unlikely to materialise, unless the markets are already susceptible to such co-ordination. The OFT notes, that collusion is most likely to materialise where there exists: (i) homogeneous products; (ii) barriers to entry; (iii) trade associations; (iv) cost commonality; and/or (v) high concentration.

The Coalition's programme statement contains a number of objectives relating to increased transparency, especially in relation to government procurement<sup>47</sup>. Policies include publishing all ICT contracts online and mandating the online disclosure of all central government spending contracts worth over £25,000. The Public Sector Transparency Board—chaired by Francis Maude—was set up by the Prime Minister to drive forward this agenda. Transparency is seen as central to the wider efficiency and reform programme, as a key driver of value for money and innovation.

### **Risk aversion**

Finally as noted by the .Econ report in most instances the public sector will have a tendency to be more risk averse and reluctant to experiment with novel ways of organising its procurement, or to choose new suppliers than the private sector. This is because where as customers of private firms are normally able to seek out alternative suppliers if any particular firm cannot deliver; this option does not normally exist in the case of public services. Equally any failure of procurement that jeopardises the ability of the public sector to provide services to the public is highly visible, and may have significant detrimental effects. As a result, avoiding failures is a high priority for the public sector. This may lead to an overly strong incentive to limit participation in public tenders to large and reputable firms, or to stick with incumbent suppliers.

## **Excessive or poorly focused competition within the market**

### **The Design of Procurement Contracts and Processes**

The .Econ report highlights the importance of the procurement process and system in securing optimal outcomes. As a result it is important that procurement processes are seen not just as merely a means to an end. Indeed the design of procurement processes plays an important role in the level of competition, the nature of competing firms, supplier incentives, and the efficiency of procurement in achieving government objectives more generally.

The .Econ report and an OECD roundtable paper notes, there is some evidence that procurement processes in the public sector are often too narrowly focussed on the short term price<sup>48</sup>. This may mean firms have an incentive to offer unrealistically low prices, leading to 'winner's curse' problems, deterring innovation or alternatively resulting in longer term problems to the commissioner.

### **Frequent competition for small contracts of similar nature**

Collusion between suppliers is more easily sustained in markets where demand is relatively stable and predictable. This is because demand volatility makes it more difficult to detect attempts by firms to grab a larger share of the market by charging lower prices, and the incentives to under-bid competitors are larger if demand is large at present, but expected to fall in the future. This means that a constant, predictable flow of demand from the public sector may increase the risk of collusion.

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<sup>47</sup> 'The Coalition: our programme for government', Cabinet Office (2010)

<sup>48</sup> 'Policy Roundtable: Public Procurement', OECD (2007)

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# Appendix 2

## Research materials

### Introduction

This appendix includes the questionnaire used for the “mini-survey” results presented in the “Commissioning and procurement behaviour” chapter and the topic guide used for the case study interviews.

### Mini-survey questionnaire

#### Skills

From your experience, to what extent would you agree or disagree with the following statements?  
Please tick one box for each statement

	Strongly Agree	Agree	Neither agree or disagree	Disagree	Strongly disagree	Don't know	Not applicable
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Public sector commissioning and procurement has a significant impact on their suppliers and the markets they operate in?

Commissioners/procurers have sufficient *understanding* of the way in which their decisions affect suppliers and the wider market?

Please briefly elaborate on your answer...

#### Incentives

##### Governance

	1	2	3	4	5	Don't know
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To what extent do you think that commissioners and procurers focus sufficiently on the right balance of factors during the commissioning/procurement process? (e.g. price, quality, value for money, risk, impact on suppliers, short-term versus long-term)

To what extent do you think that commissioners/procurers are *incentivised* to focus on the right things?

Please elaborate on your answer....

## Performance management

Have you any experience using payment by results for contracts? YES / NO

From your experience, to what extent would you agree or disagree with the following statements

	Strongly Agree	Agree	Neither agree or disagree	Disagree	Strongly disagree	Don't know	Not applicable
Payment by results would improve the commissioning process							
Current commissioning and procurement practices encourage increased efficiency							
Current commissioning and procurement practices encourage innovation							

Please elaborate....

## Controls

From your experience, to what extent would you agree or disagree with the following statements

	Strongly Agree	Agree	Neither agree or disagree	Disagree	Strongly disagree	Don't know	Not applicable
Public sector procurement rules are a constraint for buyers/suppliers?							
Public sector culture is a constraint on the commissioning/procurement process?							

Please elaborate...

## Information

From your experience, to what extent would you agree or disagree with the following statements

	Strongly Agree	Agree	Neither agree or disagree	Disagree	Strongly disagree	Don't know	Not applicable
Commissioners and procurers have sufficient information/data to make informed decisions							
Having more information would help making better decisions?							

Please elaborate... What type of information would be helpful in making buying decisions...?

## The Market

From your experience, to what extent would you agree or disagree with the following statements

	Strongly Agree	Agree	Neither agree or disagree	Disagree	Strongly disagree	Don't know	Not applicable
Commissioners and procurers engage sufficiently with current and potential suppliers							
Commissioners and procurers send clear signals to the market							
There are significant barriers to entry in this market							
Current commissioning and procurement practices help support or create competitive markets							

Please elaborate...

## Wider Issues - Political Economic Environment

From your experience, to what extent would you agree or disagree with the following statements

	Strongly Agree	Agree	Neither agree or disagree	Disagree	Strongly disagree	Don't know	Not applicable
Current government priorities e.g. localism, big society are having a significant impact on the commissioning process							
The current economic/fiscal environment has impacted on the commissioning process							
There is tension between achieving greater localism and economies of scale?							

Please elaborate...

Any other thoughts about what would improve the public sector commissioning and procurement and how it might be improved?

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# Case study interview topic guide

As this is a qualitative study, our section headings and the questions contained within them were intended as topic guides to be interpreted and elaborated upon in a manner appropriate to the specific sector and interviewee.

In structuring our interview topics we have used as a basic guide our hypotheses on the relevant influences on commissioning behaviours.

## 1. General impressions

- a. What are the current challenges they are facing?
- b. How did they think the commissioning process went in general?
- c. Why do/did commissioners they use the commissioning strategy?
- d. Have they considered or previously used alternatives?
- e. How do they see the relationship between procurement and commissioning?

## 2. Skills

- a. Do commissioners have a sufficient understanding of the commissioning processes and the way in which their decisions affect suppliers and the wider market?
  - Do commissioners have support from internal and external bodies during the process?
  - How often do they engage in collaborative or joint procurement?
- b. Do commissioners have sufficient understanding of the difference between commissioning and procurement?

## 3. Incentives and objectives

- a. What objectives do commissioners seek to achieve through commissioning? What additional objectives are there beyond getting the lowest price, e.g. innovation, diversity of supply and market expansion?
  - Do commissioners think about their ability to affect the wider market over the short/long term?
- b. How does commissioners' appraisal/performance management affect and measure their success in their commissioning role?
  - How are incentives created for innovation / greater efficiencies?
  - What constraints do they face whilst procuring? E.g. budget, EC directives, time etc.

## 4. Information

- a. Do commissioners and suppliers have sufficient data to support decision making, for example about levels of demand and supply, or about prices being paid elsewhere for the services being bought?
  - What sort of data would be useful that is not currently available?
- b. Do commissioners have sufficient data to measure the outcomes of your decisions?
  - What sort of data would be useful that is not currently available?

## 5. The market

- a. What do they think of the current state of the market?
  - How has commissioning affected the evolution of the market?
- b. How mature is the market, and what difference does this make?
- c. Does the difficulty of measuring quality present a problem for commissioners?
  - Does it lead to a strong focus on price?

- 
- d. How many suppliers are there in the market?
    - Does it contain SMEs, or is it confined to large organisations?
    - Does the contractor utilise subcontractors?
  - e. What would be the result if a supplier were to fail or be unable to fully provide their service?
    - Would you be able to quickly replace this service?
    - What switching costs do commissioners face if they decide to switch a provider?
  - f. How much buying power does the public sector buying organisation possess?
    - How is it used?
    - Is their organisation the only buyer in the market?
  - g. Do commissioners feel sufficiently able to engage with the wider market at all stages of the commissioning process?
    - Once the contract has been let, do you regulate the market any further? What sort of relationship do you have with contractor?
  - h. What, if any, are the differences between the role of commissioners in the public sector, and an equivalent role in the private sector?

## **6. Political and economic environment**

- a. What will the impact of current government priorities – localism, big society, SME's – be on the commissioning process?
  - Is there a tension between achieving scale economies and greater localism?
- b. To what extent do short term economic and financial pressures (both at a national and organizational level) influence the commissioning strategy?
  - Does it affect the importance of price?

## **7. Payment by results**

- a. Has payment by results been used in the past? Is it likely to become more prominent in future? If so, what difference will this make to the market? What are the challenges?
- b. What are the outcomes used to determine payment? Are these easily measured? What effect do you see payment by results having on the wider market, in terms of the ability of suppliers to compete?

## **8. Other**

- a. What changes do they think would improve the commissioning landscape?
- b. Is there anything else we haven't covered that is of relevance?

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# Appendix 3

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# Appendix 4

## PwC involvement in case study areas

PwC provides advisory services to much of the public sector, including most of the sectors highlighted in this report.

### Prisons

PwC were appointed, by NOMS, to a financial advisory framework, in the summer of 2007, to provide financial advice on significant transactions. This work has included: supporting negotiations for extensions to existing prisons; the competition for Belmarsh West and Maghull prisons; and supporting the initial work on considering the procurement of new large prisons programme (recently cancelled). PwC has also provided advice on competitive neutrality.

### Schools procurement

PwC has carried out a strategic study and cost benefit analysis work relating to school business managers for the National College for Leadership of Schools and Children's Services.

### Residential care homes

PwC offers advice to local authorities on redesigning their commissioning functions. We have conducted market surveys for the Department of Health; provided business recovery services to care home operators; and due diligence services in the care homes market.

### PADA

PwC has been involved in a number of elements of pension reform, including previously providing advice to PADA, before it was wound up and handed over responsibilities to the National Employment Savings Trust Corporation.

### Hospital Facilities Management

PwC provides a range of advisory services relating to hospital estates strategy and estates and facilities management, including advising on PFI and non-PFI services. We also provide advice about regulatory compliance, operational improvement and cost reduction in hospitals.

### Flexible New Deal

DWP commissioned PwC to monitor how provision of welfare to work services changes with the implementation of the Commissioning Strategy. PwC has also been awarded a place on the government's framework for Delivery Partners to deliver the Work Programme.

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## ***G. Contacts***

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***Chris Dobson***

chris.dobson@uk.pwc.com

+44 (0) 7595 849744

***Paul Dinkin***

paul.dinkin@uk.pwc.com

+44 (0)20 7212 5538

***David Lancefield***

david.lancefield@uk.pwc.com

+44 (0)20 7213 2263

[www.pwc.co.uk](http://www.pwc.co.uk)

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