

Payment by Results contracts: a legal analysis of terms and process

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Foreword

David Hunter, Consultant, Bates Wells Braithwaite

At Bates Wells Braithwaite we have seen a steady increase over the years in voluntary, community and social enterprise (VCSE) clients entering into contracts to deliver public services. In recent times more and more of these have featured a Payment-by-Results (PbR) element. The experience for our clients has not always been a happy one. Often, we have only become aware of this when contacted to help find a solution to problems that have arisen.

We were keen, therefore, to participate in NCVO's project to examine the issues around PbR contracts generally and were happy to invest the time and resource in analysing how it is that these contracts are causing so many problems. A significant part of this is, inevitably, in the detail of the contract terms themselves; it quickly became apparent that the issues extend to the whole commissioning process. Contracts are being designed without consultation. They are frequently being negotiated without VCSE organisations receiving professional advice. Sometimes this is because they are being told the contract is not negotiable in any event. Problems are also arising in implementation, where unforeseen consequences are emerging. This report seeks to identify the causes of the problems that exist and to make recommendations to avoid them in the future.

PbR contracting is a relatively new approach (certainly in terms of the extent to which it is currently being adopted) and it is still developing rapidly. We have seen that some of the points made in this report are already being addressed, in some cases by more progressive commissioners and informed providers. However, we hope that the principles articulated in the report will remain relevant and offer a standing checklist, both to commissioners and providers, for good practice around PbR contracting for some time to come.

If the result of the new process is that more of our clients in the VCSE sector are able to compete for, and deliver, PbR contracts successfully, this report will have paid for itself handsomely.

Karl Wilding, Director of Public Policy, NCVO

Paying public service providers for the impact they achieve rather than the activity they undertake is a principle that NCVO supports in full. The Government's PbR agenda seeks to put this principle into practice in public service commissioning, piloting new ways of funding providers in outsourced and open markets. But it is at this point of contractual implementation that the conceptual simplicity of the PbR principle meets a set of very complex and real challenges in practice.

So, despite immediate sympathy with PbR, we are currently seeing widespread and justified concern across the voluntary sector at the growing application of PbR across central and local public services. The fears voiced by our members are that PbR contracts being offered to the sector are poorly constructed, do not incentivise the right outcomes and do not enable the improvement of services that we all agree are so necessary. Amidst the technical complexities of

contracting and implementation, and the commercial realities of diverse provider markets, the public policy ambition of PbR is experiencing difficulties.

As a result, NCVO members who provide public services are facing PbR contracts that they cannot bid for or bid for and fail to deliver (suffering significant commercial damage in the process) and are finding whole areas of competitive specialist welfare provision repositioned out of their grasp. Our sector wants to be delivering public services; we, like this Government, believe we are exceptionally well placed to transform them for the better. However, in the technical detail of PbR we are facing artificial exclusions.

This paper, written by BWB and NCVO, therefore offers the first expert, evidence-based review of the most fundamental barrier (or potential enabler) to VCSE engagement with PbR programmes: the terms and design of the contracts themselves. Providers under a range of central and local PbR programmes have been generous in sharing their contracts and providing in-depth interviews. From this analysis we have been able to create a set of recommendations on the construction of effective PbR contracts for the voluntary sector.

This paper is part of a wider portfolio of work being produced by NCVO on PbR, to be published in Autumn 2013. This work has been steered and developed with the involvement of NCVO's PbR Working Group, a mix of voluntary sector providers, voluntary sector specialist representative bodies, solicitors, social investors and social finance intermediaries, and specialist voluntary sector accountants. We would like to thank members of the Group, particularly David Hunter at BWB, for their contributions to this paper.

Finally, I would like to thank those providers who shared their contracts with us. At moments of transition such as this, it is the organisations on the frontline who hold the best evidence about what is, and is not, working. Sharing this information with us enables NCVO to make the case to Government for improvement. These providers have done a great service to the sector in sharing their confidential commercial property with us, and we thank them for doing so.

Introduction

This paper is part of a portfolio of research and comment on PbR published by NCVO in Autumn 2013.¹ Researched and written by BWB on behalf of NCVO and with support from the NCVO PbR working group², it provides a legal analysis of current and recent PbR contracts held by VCSE providers across public services.

The past two years have seen a proliferation of PbR contracts across public services³, marking a shift towards paying providers for the *outcomes* they deliver in markets that have traditionally purchased *activities*. This centrally driven growth of PbR is a cornerstone of the Government's 'Open Public Services' agenda, an agenda which also carries the significant ambition to create "a truly level playing field between the public, private and voluntary sectors." Both profess to enable a diverse range of providers to deliver public services, driving increased efficiency and quality through competitive markets.⁴

As public service markets become more complex and varied, it is essential that commissioners understand the short and long-term implications of different contracting models and how to use PbR models in order to achieve better outcomes in diverse markets. Similarly, VCSE organisations must understand the risks inherent in different PbR contract arrangements, the cumulative effect of entering into an increasing number of such arrangements and the scope for influencing and identifying good practice among commissioners.

Evaluating the lessons learned so far, this paper provides a technical analysis of the ways in which risk is being articulated and managed between statutory commissioners in local and central government and VCSE providers. We look at the allocation of risk in the contracts themselves, and also in the wider management of risk throughout the commissioning process: from the design stage, through negotiation, distribution within supply chains and in implementation.

¹ In 2013 NCVO is publishing: a discussion paper on the viability of PbR in VCSE markets; and a 'How to' guide for commissioners considering commissioning on a PbR basis. Both will be published at <http://www.ncvo-vol.org.uk/commissioning/paymentbyresults>

² More information on the NCVO PbR working group, terms of reference, membership, and outputs can be found on the NCVO website http://www.ncvo-vol.org.uk/commissioning/paymentbyresults/working_group#purpose

³ Prior to this wave of testing, PbR has been well developed in NHS acute services and NHS mental health services. It is also a common contracting mechanism for non-welfare services, such as waste management.

⁴ Cabinet Office, 2010. 'Open Public Services White Paper' Available at: <http://files.openpublicservices.cabinetoffice.gov.uk/OpenPublicServices-WhitePaper.pdf>, p.9.

The report is split into two parts: '*Contractual terms in PbR contracts*' and '*Improving the contracting process*.' Part one provides a step by step analysis of key contract terms and of how risk is being allocated within contracts. We highlight problematic areas; point to evidence of bad practice within contracts (which providers should be avoiding signing up to); and give recommendations for how commissioners, prime contractors and VCSE providers can mitigate some of these difficulties. The second part of the report looks at the whole contracting and commissioning process as experienced by VCSE providers so far. It suggests ways in which these processes could be improved and how adverse impacts of PbR could be avoided.

This research provides a first step not only to recognising specific problems contained within PbR contracts, but in providing legal guidance to rectify and guard against repetition of PbR contracting failures. Interviewees sometimes spoke of a pressure not to publicly acknowledge current problems in PbR contracts; we hope this paper will go some way both to addressing this silence and to providing effective technical solutions.

Methodology of the Review

All contracts have been generously supplied anonymously by VCSE providers, many of whom supplemented this evidence with an in depth interview. This work has been undertaken by solicitors at BWB, led by David Hunter, in March and April 2013. BWB undertook a desk top review of a dozen PbR contracts, all of which have been anonymised. Contracts were submitted by a range of VCSE providers through NCVO's membership and BWB's wider contacts.

The contracts reviewed cover a range of services including: the Work Programme; the Youth Contract; the Innovation Fund; education, training and custodial services; substance misuse; and families with multiple problems. The commissioners therefore include: the Department for Work and Pensions; the Skills Funding Agency; the Education Funding Agency; the Ministry of Justice; and a number of local authorities. Some contracts have been subject to European Social Funding and others have been funded through social impact bonds.

The contracts reviewed include those held directly between the commissioner and the VCSE provider and those held between the VCSE provider and another provider, where the VCSE organisation is a subcontractor within a supply chain.

Widening the review beyond the contractual terms

It became apparent at the early stages of this review that limiting the analysis to only the contractual terms would not be sufficient. In a number of cases, the payment provisions within contracts were redacted before submission, making it difficult to analyse in detail how PbR impacted on the provider. It was also clear that there were a number of discrepancies between the contract terms and what was happening in practice.

To counteract these shortcomings, BWB held phone interviews with a selection of those organisations who had supplied the contracts in order to better understand the implementation and impact of the contractual terms in practice. The interview process gave a broader perspective which allowed this report to consider the contracts within the wider context of the entire commissioning process.

As such, the conclusions and recommendations within this report are based both on an analysis of the terms within PbR contracts and the experiences of providers (regarding the design, commissioning, negotiation and implementation of these contracts.)

It is worth reiterating that, although no named case studies can be drawn from the research, all the examples which have been referenced throughout this report have been derived directly from the contracts and the interviews with the providers who have participated in this review.

Key observations from PbR providers

Here we identify some of the common themes that emerged out of the interview process with VCSE providers about their overall experiences of PbR. Whilst there is general support for the principle that providers should, where possible, be paid according to the effectiveness of their service, interviewees stated several fundamental reservations about the roll-out and structuring of PbR contracts. We found widespread concern that the manner in which PbR has been executed to date has been seriously flawed and that measures are not in place to learn from, and address, these problems.

First observation: the intention and purposes of PbR are not always clear

There is concern from providers that the intentions and purposes of PbR are not always coherent, or as originally stated. Often there are a number of conflicting drivers underpinning the move to commission on a PbR basis and this has resulted in poor implementation and the inappropriate application of PbR. A number of interviewees simply felt that, in their experience, PbR is being applied to the wrong sort of services and for the wrong reasons.

This review has observed a number of cases where PbR is being used purely as an alternative way of paying for the same service, rather than as a method for improving outcomes by developing new forms of service provision. In these cases, the commissioner is procuring the same service, sometimes even using the same contract, but simply bolting on PbR as a payment mechanism. This creates additional complications for the service provider in performing the service and, as the contract retains its other, often prescriptive terms, it does not encourage or enable the provider to introduce innovation in its service delivery. This runs directly counter to one of the main arguments for using PbR: that it does stimulate service innovation. In this respect, the move to PbR can be destined to fail before it has been implemented.

A further experience highlighted by providers is that commissioners can be very linear in their approach to PbR and too often assume a direct and isolated connection between cause (i.e. the intervention or service) and effect (i.e. the result). Interventions generally occur within complex systems, and successful outcomes do not happen in isolation. For example, dealing with substance misuse can involve issues around mental health, criminal justice and housing. A provider may provide an excellent service for a drug addict; but if his partner leaves him or he loses his home, this may affect his behaviour such that the provider's target is not met. It is essential that commissioners recognise these complexities when designing PbR programmes so that in such circumstances the contract does not treat the service provided as worthless, or the provider will be discouraged from continuing to work with the client.

There needs to be clear understanding by all parties of why PbR is appropriate to a particular service, and how it may be most effectively applied on that occasion. In other words, engagement with the specifics rather than the generalities is critical in order for PbR to be applied effectively.

Second observation: the impact of PbR on the provider market is often given no consideration

The providers interviewed within this review raised concerns that there has been insufficient awareness from commissioners of the commercial impact of PbR on providers. In many cases, this is a consequence of a lack of opportunity to enter into pre-procurement dialogue with commissioners during the early stages of design.

PbR contracts create cash-flow issues for service providers who are incurring costs whilst delivering the service and awaiting payment. They also introduce additional risk for the service providers, in terms of incurring this expenditure without the certainty of receiving the income through the contract to offset it. This introduces issues for the trustees or directors of such organisations about the appropriate levels of risk to adopt and for investors in, or lenders to, the organisation around the prospect of being repaid. Clearly, this is magnified where the use of PbR in a market is widespread.

Providers offered examples of how cash-flow considerations and constraints have impacted organisational behaviour: providers have had to cross-subsidise their PbR work (which is unlikely to be a sustainable practice); providers have had to limit the volume of PbR work they deliver at a time (restricting their ability to grow); and providers have had to seek loans to cover the delay in payments and had to recover costs through their pricing.

The failure by commissioners to acknowledge the cumulative impact of PbR on providers means that over time they run the risk of adversely affecting the diversity of the market of providers they can access; the quality of the services being delivered to the public; and the value they are managing to secure from their commissioning activity.

There is also a danger, already evident in some cases, of VCSE organisations feeling they have to bid for PbR contracts in order to continue to serve their core user groups; doing so without a full understanding of the commitments they are taking on, or the implications for their on-going viability. There are lessons for the sector here in terms of ensuring they know exactly what they are taking on, and the importance of declining to do so where the risks are disproportionate.

Third observation: there is a lack of fruitful evaluation and learning from PbR contracts

A recurrent complaint from providers we interviewed was around the increased bureaucracy introduced by PbR contracting, an increase in costs associated with contract management, and a simultaneous decrease in overall effectiveness. This may well be an inevitable part of transition to PbR programmes: however, what causes the greatest consternation is that this evidence is not being well used to drive improvements in future contracting.

At the same time, individuals have also experienced a lot of pressure not to acknowledge these problems, but to instead present a positive picture. There appears to be a significant and worrying gap between parties' experience on the ground delivering the service and what is being reported back up the management chain. Even though there is a recognition that contracts are not working, there is huge political pressure to declare the contracts a success. There is also commercial pressure for providers to show they are able to cope with the emerging market structures, and continue to serve their target client bases. Ultimately, this is masking structural problems with the application of PbR to VCSE markets: problems that need addressing.

Underlying this is the issue previously described: there is a lack of understanding and clarity about why contracts are being let on a PbR basis. Providers have found in some cases that commissioners have given the impression that PbR was being used because it was the political 'flavour of the month', rather than for a coherent strategic purpose. Whilst political will is not wholly negative, and market change has to be pushed from somewhere, this should not mean that evidence about what is and isn't working from all stakeholders, including VCSE providers, should be overlooked or disregarded.

Part I: Contractual terms in PbR contracts

This chapter examines the content of the PbR contracts submitted for review. We look at the main provisions that indicate whether there is an appropriate allocation of risk between the parties involved, and highlight examples that illustrate where bad practice may be creeping in to a contract.

This chapter explores the following elements of PbR contracts:

- Prescriptive provisions
- Contract alterations
- Subcontracting
- Payment metrics
- Volume guarantees
- Liability and indemnities
- Default and termination
- Voluntary termination
- Data
- Contract form

This chapter is useful to VCSE organisations in identifying contractual provisions which they should be avoiding and suggests ways in which they can mitigate some of the challenges posed by certain provisions. It also points to ways in which commissioners and other parties can address potentially damaging terms within PbR contracts.

Prescriptive provisions within contracts:

PbR introduces a significant shift in risk profile towards the provider and this shift needs to be reflected in the parties' contractual rights and responsibilities. Where providers are being paid for the results that they achieve, rather than the activities they perform, the contract should be less prescriptive about how the service is to be delivered.

However, a common problem observed by this review has been the inclusion of overly prescriptive provisions within contracts. Clearly statutory duties impose requirements which must be met, but prescriptive contract terms frequently go far beyond this. This has occurred on a number of occasions where contracts have been re-tendered as PbR contracts, yet the terms have remained identical to those within the pre-PbR contract. In these circumstances, all that has changed is the way in which payments are made.

Examples of these contractual terms in PbR contracts that have been seen by this review are those that require the contractor to provide the services:

- Strictly in accordance with the specification
- In accordance with the commissioner's internal policies (all of them, as they may be amended from time to time)
- Where time is of the essence
- In a professional and courteous manner

- Notifying the commissioner in advance of any changes to staffing
- In all respects to the satisfaction of the commissioner
- Complying with all reasonable requests or directions of the commissioner

The first of these may not be problematic, depending upon what the specification says. If it simply states the outcomes that need to be met, it may be less of an issue. Usually, however, the specification will go into some detail in terms of what the provider is expected to be doing. In the context of outcomes-based contracts, where payment is dependent upon achieving the outcomes, the provider needs to have the discretion to take the steps it thinks necessary to meet those outcomes, whether or not they appear in the specification.

Similarly, clauses which set out how the contractor's employees are expected to perform the services (e.g. "in a professional manner") or stipulating the quality or quantity of staff engaged in providing the service are unnecessary and inappropriate where the commissioner is only paying when specific outcomes are achieved. The same applies to provisions stating the services have to be provided to the satisfaction of, or taking into account the instructions of, the commissioner. If this level of involvement is required by the commissioner, it should be paying an upfront fee for the service in question.

Another provision which causes difficulty is around monitoring. Whilst some ability to monitor service delivery will be appropriate in certain circumstances (for example where there is evidence of poor performance or complaints from clients), contracts we have seen contain the right to monitor and inspect a provider's work at several different places in the contract. This creates the possibility for confusion on the part of both the commissioner and the provider in terms of understanding the extent (and purpose) of different contractual rights. Exercise of these rights without this overview may, in turn, lead to costly disruption for the provider and, potentially, unnecessary expense for the commissioner.

Recommendations for commissioners:

Too often, when designing the PbR contract, the starting point for commissioners has been to duplicate contractual terms which have been used in previous contracts. Instead, the commissioner should:

- begin by examining what it is seeking to achieve through the contract, and then assess what rights it will require in order to monitor the provider in the context of this service and the outcomes that are sought;
- refrain from including provisions which go beyond this, and should not seek to simply re-apply the rights that it has benefited from in other contracts.
- seek to examine what impact exercising these rights will have on the service, and on the outcomes and end users; they should consider whether this impact is proportionate. This is necessary to ensure that an appropriate and workable balance is struck between the different interests at large.

Recommendations for providers:

Providers should look out for the above clauses when signing a PbR contract. For the VCSE organisation it is important to remember that whilst some of these may appear minor points in isolation, the cumulative impact may be significant. For example, if a commissioner (or prime contractor) exercises all their rights in some of the current PbR contracts in the market, there would be an administrative burden placed upon providers that could impair their ability to deliver the service and have a damaging economic impact upon them.

Allowing alterations of the contract:

A number of the PbR contracts examined in this review contained provisions which enabled the commissioner to change its requirements, or impose additional obligations throughout the life of the contract. Often this stipulation is a sub-clause in other provisions and includes the phrase "or such additional / alternative requirements as the Commissioner may impose from time to time."

This potentially exposes the provider to having to change the service it is providing, or how it is providing it, without the ability to reflect any price implications of such a change in the payments it is receiving.

This is not to say variations to such contracts should always be resisted. Sometimes, particularly where a new service is being commissioned (for example, using a social impact bond), it may be very prudent of the parties to build into the contract a process to review how the contract is being performed in practice and whether adjustments may be introduced to increase the prospect of achieving the desired outcomes. However, this would need to leave the parties, as far as possible, in no materially better or worse position than when the contract was signed; rather than permitting one party to change the contract terms unilaterally to the detriment of another.

Recommendations for commissioners:

The contract should either:

- not contain any such rights for the commissioner and should provide certainty to all parties from the outset; or
- there should be a variation mechanism that allows discussion between the parties and agreement on any adjustments to the contract to ensure that any such changes do not impact one party disproportionately.

Subcontracting:

This issue is of particular relevance to VCSE organisations that are providing services as part of a supply chain, or are considering doing so. There have been numerous examples to date of prime contractors passing down the terms of the head contracts in full to their supply chain with no mediation of the risks involved.

Worryingly, we have come across some examples of prime contractors imposing the terms in their subcontracts that their prime contract prohibited, such as payment of the subcontractor being conditional on the contractor receiving payment from the commissioner. This is indicative both of the lack of scrutiny by commissioners previously to arrangements within supply chains, and of the inability of VCSE organisations to negotiate effectively the terms in their own subcontracts.

Further problems are seen where Tier 2 VCSE organisations have wished to engage supply chain partners themselves. If the contract terms that it has signed up to itself are very prescriptive this inhibits its ability to work with the parties it wishes to, on the terms it would prefer. From the evidence we have seen, however, there is more flexibility at this Tier 2 level with several VCSE organisations taking steps to come up with a further subcontract which is workable for both parties.

Recommendations for commissioners:

There have been a number of positive steps towards a more proactive role from commissioners in the design of subcontracts.

The Innovation Fund Round 2 (2012) template agreement demonstrates that the DWP has recognised the need for the commissioner to address the nature of the prime contractor's relationship with its supply chain. This contract anticipates that:

- The services will be performed entirely by Delivery Bodies (i.e. subcontractors)
- The Delivery Bodies shall be named in the contract. More may be appointed and the original ones may be replaced or terminated with the approval of the commissioner
- The commissioner has been induced to enter into the contract by the inclusion of the Delivery Bodies in the tender

However, we suggest that this could be developed further. For example:

- The prime contractor could be required to identify in its tender not only *who* is part of its supply chain, but *how* it will work with it. This could include specifying the amount of work (by proportion of contract value) each Delivery Body is expected to perform.
- It could identify the nature of work being undertaken by Delivery Bodies, so there is transparency around provision of difficult niche services (and less opportunity for cherry picking).

- It could include obligations upon the prime contractor to manage the contract in a manner consistent with these commitments, and rights for the commissioner to require the contractor to remedy any failure to meet such obligations.

Another example of good practice comes from the Cabinet Office Centre for Social Impact Bonds which has published a template contract (2013), along with guidance on how to use it.⁵

This includes:

- provisions requiring the Contractor to conform to its tender submission in terms of use of the proposed supply chain;
- it includes specifying the manner in which future subcontractors may be procured;
- and it specifies some of the terms on which the Contractor is expected to subcontract with third parties.

At the time of going to press, the Ministry of Justice is about to issue its proposals for subcontracting within the Transforming Rehabilitation programme. We have not seen the detail of the proposals but know that MoJ has expressed an intention to address this issue, so it will be worth looking at how they intend to do this, and what the market response to it is.

Payment metrics:

The payment metric is often the part of the contract where a service provider's difficulties with PbR contracting converge. Here we outline some of the common complaints presented by the contracts we reviewed which parties to future PbR contracts should look out for and avoid.

- *Payments attaching to too many targets.*

We have seen examples of PbR contracts that have so many targets for payment that the commissioner does not have the resources to monitor them accurately. This means that the commissioner ends up making the payments without reference to whether all performance measures have been achieved.

- *Payments attaching to targets that are beyond the providers' control.*

We have found examples of service providers being required to take the risk of achieving targets that are not within their control. This may happen, for example, where there is a full flow down of the main contract by the prime contractor to a service provider. The service

⁵ More information on the Centre for Social Impact Bond's template contract is available here: http://data.gov.uk/sib_knowledge_box/sib-template-contract-uk

provider does not have sufficient influence over aspects of the support package for users in order to determine the overall outcome -yet receiving payments is dependent on that outcome being achieved.

- *Payments being deferred*

It is inevitable, in a PbR scenario, that there will be a delay between when the service is performed and when the commissioner can see that the results in question have materialised. Problems arise, however, when the gap between the activities of the provider and the point at which the commissioner will make a payment is too great.

We have seen examples of payments being deferred for periods of time which undermine the financial viability of service providers, extending to years on occasion. Deferring payments can threaten the performance of the contract itself; can prevent the service provider from providing a similar service elsewhere on equivalent terms (due to the accumulation of risk involved); or may even push it into insolvency. For many organisations simply do not have the working capital to sustain their activities until the deferred payments are made.

Social impact bonds offer a mechanism to address this problem in some situations, by passing the risk of deferred payments to third party social investors. However, there is a financial cost attached to this, so the deferral of payments has to make sense in the wider picture of what the commissioner is seeking to achieve.

- *Late payments*

VCSE organisations need to be aware of the consequences of late payments. Most PbR contracts do provide that interest will be payable where payments are late, but this often does not apply until 30 days following the payment date.

Where payments may be deferred by the nature of the contract, the fact that interest does not apply immediately could possibly be the straw that breaks the camel's back— particularly if it is a recurring problem. It should be considered that the right to interest should arise much sooner, primarily as an incentive for the commissioner to make timely payments.

- *Payments attaching to the 'wrong' targets*

We have also heard from providers that the way in which payments are set against targets, i.e. the amount which is set and the triggers which are put in place, can impact provider behaviour in a way which is detrimental to the service.

Recommendations for providers:

There may be limited scope for a VCSE organisation to influence the detail of a payment mechanism when they are a subcontractor. However, they can influence how the terms are stepped down and also the manner in which payments flow to them.

For example, we have seen a subcontract which states that the prime contractor will not pay its subcontractors unless it has itself been paid by the commissioner. This is a clause that should have certainly been resisted by the subcontractor. If the subcontractor has met its contractual obligations it should be paid for doing so, without reference to how the prime manages its relationship with the commissioner.

We have heard evidence that the commissioning and negotiation processes seem to offer little scope for service providers to engage in detail with the payment arrangements (or if the opportunity is there, organisations are ill-prepared to take advantage of it). The consequence, all too often, is that the service provider finds itself trying to work with a flawed model. We explore improvements in commissioning and negotiation in the following chapter.

Volume Guarantees:

Some of the contracts we reviewed explicitly state that there are no guarantees of the volume of business that may be offered to the service provider. Whilst this is understandable on one level, as there are many variables at play which may affect numbers of service users coming forward, it might be appropriate for contracts to reflect the risk of uncertain volumes and the impact this has on operational and financial planning.

Recommendations for commissioners:

It may be appropriate for provisions in the contract to:

- Recognise that bids have been prepared on assumptions of certain levels of business.
- Contain a commitment to review the contract structure if circumstances outside the parties' control mean anticipated volumes of activity are not forthcoming.
- Seek a commitment from prime contractors to take active steps to preserve the anticipated proportionate levels of activity between supply chain members (subject to satisfactory performance of the contract by those parties and the assumptions upon which those levels were based remaining relevant).

Recommendations for providers:

The appropriateness of such provisions will vary depending on the circumstances in question; service providers should be sensitive to what may be realistic to demand in this respect and to press for those demands which are so.

Liability and Indemnities⁶:

This is a part of the contract which can have a direct and material impact on the level of risk a party is assuming. Whilst an indemnity does not, of itself, change the liability that a party may incur in relation to a matter; it can increase the prospect of a claim being brought in regard to it. What falls within the indemnity, and how it operates, can therefore be a significant matter that is worth paying attention to.

Some of the PbR contracts we reviewed contained very wide indemnities. For example, indemnities covering both direct and indirect losses and/or relating to claims *however arising* (rather than only where the provider is negligent or in breach) and with no limits on the liability of the service providers.

We have also seen evidence of more promising practices, with indemnities not so wide ranging and with annual and aggregate limits on liability appearing (although the size of these caps vary significantly). However, the caps to liabilities often sit alongside obligations to maintain professional indemnity cover of an amount equivalent to the liability limit. These obligations can extend to maintaining such insurance for six years following the end of the contract. This may be a considerable commitment, possibly disproportionate to the term and value of the contract itself, particularly if it goes beyond what would be the service provider's usual business practice.

Recommendations for commissioners and providers

This is an aspect of contracts that is always worth careful scrutiny and often worth seeking expert advice upon.

All parties to the contract should consider the following:

- Does it relate to breaches of contract and negligence only, or does it cover any acts of the relevant party (including potentially proper performance of the contract)?
- Does it relate to claims that are a direct result of such matters, or anything arising from, or connected with, such matters in any way?
- Does it relate to direct losses only, or any losses - including, for example, loss of profits?

It is desirable (and reasonably common in commercial agreements) for parties to limit their liability to one another. This is often by reference either to the amount they are to be paid under the contract, or to the insurance cover they may have in place in respect of such liability.

⁶ More information on indemnities and warranties can be found on the NCVO website: <http://www.ncvo-vol.org.uk/advice-support/public-service-delivery/commissioning-procurement/contracts-key-issues#warranties>

Data:

There are two aspects to data reporting which we have observed as problematic during this review and which are worthy of further attention.

Firstly, the confidentiality restrictions included within contracts mean that it is very difficult for parties to develop a sense of comparative success and to understand what does and does not work, and where benchmarks should be set. There is a degree to which commercial confidentiality needs to be taken into account; but this consideration should not be allowed to restrict information that could usefully improve both commissioning practice and service delivery.

There are many examples of contracts which start from a presumption of confidentiality, then have exclusions to that presumption. A more constructive approach is to start with the presumption that information relating to the contract shall be capable of disclosure, save where it has been specifically agreed as being commercially sensitive. Thus, the process of agreeing what is commercially sensitive itself needs to be one which requires each item to be considered on its merits, taking into account, for example, Freedom of Information Act requirements and OGC guidance: so that this does not become a means of subverting the intention behind the provisions. Making restrictions on disclosure time limited is another way to avoid information remaining secret for longer than is necessary.

The second, related, issue is that restrictions on the ability of parties to share information is inhibiting the scope for lessons to be learnt around what is, and is not, best practice in contract delivery. From our interviews with providers, there was a commonly held view that difficulties were being experienced in the implementation of contracts on the ground; nevertheless, details around this were not being communicated, sometimes even within the organisations themselves, let alone to a wider audience: because of data restrictions within the contract. This clearly inhibits the ability to implement improvements and to avoid mistakes being replicated elsewhere.

Recommendations for commissioners

If PbR is to be adopted widely as a matter of policy, the prospect of it being effective will depend on recognising the bigger picture and the benefits of sharing information wherever practicable, rather than keeping it within the tightest possible circle. Again, this requires commissioners to adapt their standard provisions around data to reflect the nature of the particular contract, rather than simply repeating them.

Default and termination:

It is necessary that VCSE providers understand the consequences of different breaches of the contracts they sign, including the rights and remedies given to their counter-party; the triggers for these; and the impact which they will have.

The commissioner may exercise certain rights in relation to certain breaches, including:

- the right to increase their monitoring of how the service is performed;
- the right to require remedial action;
- the right to call for a performance improvement plan;
- the right to step in and deliver the failing part of the service;
- and, ultimately, the right to terminate.

This review has observed a number of PbR contracts where insufficient distinction is drawn between different types of breach and the rights which they incur. As such, a relatively minor breach or technical infringement of the contract may expose the service provider to the risk of losing the whole contract. Whilst it may be unlikely that such a right will be exercised if the breach is only minor, the threat still remains for the service provider. This leaves them vulnerable to a change in the commissioner's policies or objectives being put into effect through the manipulation of the contract in this way. Where there is a prime contractor who seeks to step down the head contract provisions, it also exposes the subcontractor to the risk that the prime contractor may look to exploit those provisions, if it becomes commercially expedient to do so. This was a situation experienced by some of those participating in our research.

A further problem is that some of the PbR contracts we have seen make no provision for termination to be possible if there are material breaches on the part of the commissioner. Possible breaches include non-payment or preventing the service provider from being able to perform the contract in some way. These breaches may have a serious impact on the service provider if they are recurring. It is not unreasonable to require a right to bring the contract to an end in such circumstances.

Recommendations for commissioners and providers:

It is important that rights attaching to breaches of contract are proportionate. This will ensure that the cost of providing the service is not increased, except where necessary to address a problem with the service, and that the contract does not terminate for anything less than a very serious breach. For example, there should be a clear relationship between the potential remedies described above and the level of default; so that increases in severity are appropriately reflected and that relatively minor breaches do not trigger disproportionate remedies.

It is desirable for triggers for each right or remedy to be objective wherever possible, rather than being expressed to be in the opinion of the commissioner. Even where it is required that this opinion be 'reasonable' we have found this stipulation to be insufficient in safeguarding against subjective interpretations of breach.

Provisions for breaches on behalf of the commissioner should also appear within contracts. These provisions should not be objectionable for the commissioner, as the occurrence of such breaches remain within its control. It also provides comfort to a service provider that, if the relationship has irretrievably broken down without fault on its part, it may bring it to an end before the detrimental impact on its business has become too great.

Voluntary termination:

Increasingly, voluntary rights to terminate are appearing within contracts and are being made available to both parties: with some recognition that termination payments may be appropriate.

For the service provider, whenever the contract terminates early, this may deny it the opportunity to make a return on its activities. It may have spent considerable sums bidding for the contract on the assumption that certain levels of income would be generated over a certain period of time. It may also have invested in staff and capital equipment on the same basis.

Recommendations for commissioners and providers:

If the commissioner exercises a right to terminate the contract before the original expiry date, it is reasonable to argue that the provider should be compensated for foreseeable losses it incurs as a result of the commissioner exercising its discretion.

Of course, if it is the service provider who is exercising the right to terminate early, or responsible for early termination through its default, compensation from the commissioner should not apply. However, it is possible that there may be payments due in the future, for services already provided, that the service provider should still be entitled to.

We have seen examples of commissioners seeking payments from the service provider where a contract has terminated through the service provider's default, in order to cover the costs of the commissioner putting new arrangements in place. Whether this is appropriate or not may depend upon the length of the contract period remaining (i.e. is it just bringing forward a cost the commissioner would incur soon anyway?). If appropriate at all, it should be limited to the direct costs to the commissioner that cannot be mitigated and are otherwise irrecoverable: arising from the contract termination.

Form of contract:

This review has observed that some prime contractors have adopted an approach where they have developed their own standard subcontract in response to certain PbR programmes. They have then used a shortened version of the contract when subcontracting to their supply chain, which has incorporated their standard subcontract terms by reference. This can make sense for the prime contractor, but may be problematic for the supply chain member, as it makes it difficult to get a complete picture of the obligations they are taking on. There can be a temptation to focus on the more manageable shorter document and miss some of the obligations which might be buried in the larger one.

There can also be inconsistency between the two documents and in those circumstances it is important to know which provisions take precedence and not assume it is possible to rely on those which are more beneficial.

Recommendations for providers:

It may be difficult to dissuade a prime contractor from following this approach when they have invested time in developing it, but it may be useful to consider whether this is the basis for a constructive long term relationship. Extra care needs to be taken when contracting on this basis.

Part II: Improving the contracting process

There are many elements to contracting effectively on a PbR basis, in addition to the contract terms themselves. This chapter examines the challenges that are posed in designing, commissioning, negotiating and managing PbR contracts. For each stage, it highlights the consequences of not addressing these challenges and suggests ways in which these processes could be improved.

Designing PbR contracts

It is important to recognise that PbR contracts can be complicated to construct. There are a lot of different drivers that need to be accommodated. These sometimes conflict, complicating things still further. In designing the contract, consideration needs to be given to the consequences that may flow from adopting particular approaches. Many of the consequences of poor design have been observed in the previous chapter. Here we identify some of the motivations that may underpin PbR contracts and some of the challenges that they create.

Identifying appropriate targets

If the intent behind procuring the service is for the stakeholders to work towards shared outcomes which are focused on improving the condition of service users, it would seem beneficial, and necessary, to engage at the outset of the process with service users, and those who have in depth experience of working with them, to assess what interventions are likely to be most effective in delivering the desired outcomes.

Experience to date, however, is that contracts often contain targets that have not been the subject of consultation and which are presented as a *fait accompli*. This means that the opportunity to construct something informed by the actual experience of those most directly affected by the proposed contract is missed, often resulting in a substandard contract.

For example, a key problem identified by providers is where the targets to be met in order to trigger payment are disconnected from the desired outcome. In these circumstances, providers find it necessary to focus on these targets in order to ensure the financial stability of the organisation; but this is potentially at the expense of the ultimate outcome the contract is intended to deliver.

In practice, we have seen contracts which are not working being amended whilst operational. It would clearly be preferable, from all parties' perspectives, to get this right from the outset. There is also the potential risk of a procurement challenge if a contract is changed too much once it has been let.

Enabling, rather than inhibiting, innovation

If the intent is to encourage innovation on the part of service providers, then the metrics need to provide the scope to enable this. If the contracting authority is procuring statutory services, the overriding duty will be to meet the statutory requirements: scope to innovate will be restricted by this. PbR, therefore, may not be appropriate in relation to these services at all or, if

so, it should be used with a clear understanding by all parties that the scope for innovation shall be limited.

Taking commercial and practical considerations into account

Examples were offered where there is a disconnect between some of the targets in a contract and what is commercially feasible. The way the payment mechanism was set meant many providers simply could not carry the cash-flow consequences of waiting for payments deferred for so long, and so were denied the opportunity to deliver the service: regardless of their ability to do so.

Other problems were encountered around the practicalities of achieving some of the targets. For example, in some cases assumptions were made around the co-operation of other public authorities that was not necessarily forthcoming; or that circumstances outside of the contract would remain static, when this was not the case. Whilst there will always be some element of unpredictability, consultation with end users and providers on the structuring of the targets could, again, reduce the prospect of difficulties arising in the implementation of such contracts.

Contractual theory and practical implementation

There is a temptation, in designing the contract, to make all the processes as coherent as possible. This may involve anticipating different permutations and putting processes in place to be followed if they arise. A danger with this is that it can undermine how the provider works with the users, which in turn has a negative impact on the outcomes.

For example, in attempting to provide a robust evidence base for making payments, PbR contracts have required service users to complete surveys or attend meetings that do not have direct relevance to why they are engaging with the provider. They do not, of themselves, contribute to achieving the outcomes the parties are seeking and can have the effect of alienating the service users so that some disengage with the process: thereby achieving the opposite effect to that intended.

The inherent danger of setting targets

When confronted with a payment mechanism, providers will devote effort and attention to establishing the most effective ways of maximising the payments flowing from it. At one end of the spectrum, focus solely on this may lead potentially to gaming the system, which may increase financial returns, but may contribute less to the attainment of the overall outcomes the contract is intended to achieve. For example, it can motivate 'creaming and parking,' where providers work with the service users who are 'easiest' to help, whilst 'parking' those who would require more expensive or sustained interventions. The converse approach may see a provider ignoring the payment mechanism altogether and focusing exclusively on the end users; possibly finding that they are doing good work from their service users' perspective in a way that will not deliver the payments necessary to continue the service .

Neither practice is desirable, but getting the balance right is not straightforward. There is a danger that the awareness of behaviours such as creaming and parking, whereby service

providers operate the contract to extract maximum payments and avoid dealing with the more challenging clients, leads to contracts becoming increasingly complicated and/or bureaucratic. Huge efforts may go into increasingly elaborate ways to prevent such behaviours, but the effect may be to make contract management and service delivery more difficult in other respects: the overall benefit of the approach may be marginal at best. Our review has seen contracts that include serial requirements being put in place to try and anticipate ways in which the contract might be 'gamed': the result being an overly bureaucratic process that has made the delivery process more difficult.

Even when a decision has been taken to explore a PbR approach, when a potential structure has been identified, it may be worth reflecting on the extent to which the commissioner is confident it will deliver improved outcomes and will not simply stimulate different behaviours.

Understanding underlying motivations

Using financial rewards to incentivise improved performance may be effective for profit driven organisations. However, this is not the reason that mission driven organisations exist. In both cases, there is a relationship between the two. For the 'for profit' company, as a rule, they will aim to deliver the outcomes in whatever way, and to whatever extent, they can do so most profitably. For the 'not for profit' organisations, they need to trigger the payments in order to be able to continue to deliver their services.

There are also the priorities of the commissioner and the end uses to be taken into account. In many cases, it may be possible to find the common ground between the parties and, working from that (taking into account the different motivations each may have for reaching it) design a contract that offers appropriate incentives for each to work towards it. It may be a challenge to accomplish this without sacrificing simplicity.

Commissioning PbR contracts

Here we identify some of the issues that may affect how the commissioning process contributes to the overall success of a PbR contract. We explore the importance of local context, local market knowledge, and the facilitation of collaborative delivery structures.

Recognising existing relationships with service users

Commissioning any service, even if it has not been contracted on a PbR basis previously, does not take place in a vacuum. There are existing services, existing providers, and existing relationships. Whilst there may be scope to improve the efficiency of these to varying degrees it will be desirable to protect, if possible, what works well currently - rather than introduce change merely for political expediency. Particularly in the context of national programmes, it is easy to see how local knowledge may be lost to the commissioning process: this loss can be hugely detrimental to the achievement of successful outcomes.

Often, the existing relationships between service users and local providers have taken a long time to nurture. These relationships have the potential to have the deepest impact, but are also fragile and vulnerable to being lost by sweeping new approaches that favour economies of

scale. An example of this, that we were presented with, was where there had been some very well established, existing relationships with service users and local providers within a region. However, when a large prime came in to run the contract, even though in the first instance the same staff were working with the clients (having TUPE'd to the new contractor), over time a combination of the way the prime preferred to work, and the fact that many of the original staff left the organisation, meant the relationships and local knowledge became largely lost.

It is essential that commissioners recognise the value, and also fragility, of the relationships within communities which are already in place and take this into account within the procurement of the new services. We have heard concerns that the imposition of national procurement models, including those using a PbR payment structure, have threatened existing local relationships between providers and other agencies. There is clearly a tension between size and a uniform approach offering economies of scale and the price paid in failing to take into account local conditions. The challenge may be to have a template approach with scope for local interpretation to reflect local circumstances.

Understanding local markets

Commissioners should understand the local market context into which they are intending to introduce PbR. Knowing what other PbR contracts are being let within the locality and within particular public service markets is important so commissioners can appreciate what financial and commercial pressures providers are already under.

As described earlier, the majority of providers we spoke to have had to cross-subsidise PbR contracts with income from other sources, including non-PbR contracts, in order to continue to deliver to their client base. This is not an option available to some smaller organisations, and will not be available to larger ones either, if more and more of their business is delivered through such arrangements.

Even if some providers are able to fund their activities to be able to respond on this basis, this may mean the market consists of parties that can demonstrate they are effective at obtaining finance: not that they are necessarily the best at delivering the outcomes. To some extent, the two will correspond: but not always. Without acknowledging this, and seeking to identify and provide for the exceptions, diversity and quality may be lost.

Commissioners need to be aware of the systemic impacts of PbR. While it is important for commissioners to achieve value for money and not to enter into contracts which expose them unduly to potential liabilities, their actions and omissions have a wider impact on the creation of diverse and healthy economies of providers. A commissioner seeking to achieve the optimal terms for itself in purchasing a particular service should balance this with a consideration of how the cumulative impact of its actions, along with those of other commissioners, may have a negative impact when aggregated: even if they appear positive in isolation.

The consequences of not evaluating the current extent and impact of PbR contracts in their market is that commissioners may find that they cannot attract good service providers to bid for their contracts, because of the cumulative impact of PbR in the market. Or they may find that by the time the contract needs to be replaced, the market has shrunk for the same reason.

If PbR is adopted across public sector commissioning, lots of VCSE organisations will not go for work they might have been well placed to provide to a high standard because they lack the capability to deliver under these payment mechanisms. And if public sector commissioners procure their own PbR contracts without any sense of what related PbR contracts may be in existence or planned, providers may find they are trying to hit contradictory, rather than complementary, targets.

Market engagement pre-procurement

We have already identified the potential benefits of consulting with service users and providers to explore what may be the most effective metrics to use in their PbR contract. Engagement with service providers is also desirable so that commissioners may be better informed around what is technically and commercially deliverable, before committing to a particular approach.

This may be a means of taking into account some of the local factors referred to above. It may also help the commissioner to understand the market and the role it has in shaping that market.

Collaborative delivery structures

Often, PbR contracts require service providers to work with others to deliver the required outcomes; whether by forming joint ventures, consortia or other forms of partnership. These need to work effectively; firstly to put together bids that are clear and convincing, and, if successful, to perform the services and deliver those outcomes.

Productive working relationships are established and built on mutual trust. Recognising this, commissioners might consider in relation to specific procurements how to structure them to avoid successful existing relationships being lost unnecessarily and to allow new relationships to be established on bases other than expediency around bid requirements.

It needs to be recognised that it takes time to develop such relationships. Ideally, the process would proceed once the commissioner was confident those relationships had become suitably well established. Currently, we tend to be at the other end of the spectrum and procurement timetables are set with no allowance made for what is required to develop such relationships. Consequently, they are entirely pragmatic, doing what is necessary to comply with the process with time for nothing more; if a consortium or contractor is successful, the relationship then develops entirely during the operation of the contract itself.

Supply chain management

A related issue for a commissioner is the approach to take to supply chain management. Often the practice, to date, has been to seek reassurance that a supply chain exists to deliver the services and outcomes, as part of the procurement exercise; then to regard how the successful bidder engages with its supply chain as a matter for it, and not for the commissioner.

This has led to many problems, most notably in relation to the Work Programme, where VCSE organisations that have been part of successful bids have subsequently found that they have received few referrals, or not on terms that they can work with commercially. An NCVO survey

of VCSE subcontractors in the Work Programme found that half of the respondents were receiving significantly less referrals than expected. 70 per cent fear their contracts will not be viable for the full term: nearly half of respondents are subsidising their service delivery with their own reserves.⁷

The recent announcements in relation to the MoJ's Transforming Rehabilitation programme indicate that commissioners are listening to these complaints and recognising there is a role for them in being more prescriptive about both what they require to see as part of the procurement process and how this translates into contractual obligations on the prime contractor. At the time of writing the detail remains to be seen, but this is a commendable principle to adopt.

Negotiation of PbR contracts

Here we look at some of the challenges that VCSE organisations have found in negotiating PbR contracts, with a view to identifying how more effective engagement through this process by the relevant parties may lead to more appropriate contracts being used. We address the roles that the VCSE sector, commissioners and prime providers should play in negotiation and highlight poor practice.

The opportunity to negotiate

One of the most basic problems experienced by VCSE organisations around negotiating contract terms is that they are given no opportunity to do so. This was the experience of the majority of providers who we spoke to: both those contracting directly with commissioners and with prime contractors. As has been described in the previous chapter, a lack of negotiation around terms can lead to a poor contract.

Sometimes this arises because the service is commenced before the contract has been concluded and signed. In these circumstances, as all attention is focussed on delivering the service, the contract is regarded as a lower priority and is signed without due attention.

We heard evidence of commissioners and primes presenting contracts as non-negotiable. If the VCSE organisation wants to work (or continue working) with the end users in question, it feels it has no option but to sign the contract, whatever its terms.

Neither of the above approaches represent good practice. They may also prove counter-productive for the commissioner or prime contractor. A proper negotiation process may have revealed problems with the contract that could be resolved before the parties commit to

⁷ NCVO. 2012. *The Work Programme - Perceptions and Experiences of the Voluntary Sector.* Available at: http://www.ncvo-vol.org.uk/sites/default/files/sig_survey_june_2012_report_17.9.12.pdf, p.10, 13.

working according to its terms. In addition, if a VCSE organisation signs a contract which it then cannot deliver, this potentially creates problems for the commissioner, the prime contractor and the end users that could have been avoided by adopting a more balanced approach from the outset.

The manner in which the negotiation (or lack of negotiation) is conducted can have an impact on how the parties approach the contract when it is operational. For example, being told 'take it or leave it' is not conducive to establishing a collaborative working relationship.

The VCSE capacity to negotiate

In some cases, even when presented with the opportunity to negotiate, providers have passed this up because they lack the experience and/or the resources to engage in detail in contract negotiations.

Using external professional expertise can feel prohibitively expensive and it often seems simpler to sign up to what is presented to them. This can be a false economy when, as has been described, problems emerge later down the line.⁸

The commissioner's role in negotiation

It is reasonable to assume there is a consensus between the parties against devoting lots of time and resource to negotiating the contract terms. However, there is no consensus around whether the duty on the commissioner is to issue and negotiate a contract that is as favourable to itself as possible, or to start out with a fair contract that all parties should be able to sign up to with a reasonable degree of confidence.

It is in the commissioner's interest, at a systemic level, to ensure there is a healthy and diverse range of provision of the services, so as to not see monopolistic or oligopolistic markets in the future (where one provider or a small number of providers control supply and pricing within the market).

For this reason, the commissioner should consider the various degrees to which operational provisions will be passed down the supply chain, and the impact which this will have relative to the size and sector of organisations. When negotiating the contract with the prime contractor,

⁸ NCVO encourages all VCSE providers to understand the costs and other implications before entering into negotiations. NCVO offers free advice on how to negotiate (http://www.ncvo-vol.org.uk/psd/commissioning/relationships_negotiation) and key contract terms to look for (<http://www.ncvo-vol.org.uk/advice-support/public-service-delivery/commissioning-procurement/contracts-key-issues>). For training on negotiation and risk assessment in 2013/14, see the national training programme run by NCVO, ACEVO, NAVCA and Social Enterprise UK, *Commercial Masterclasses*: <http://knowhownonprofit.org/funding/service/commercial-masterclasses>

the commissioner should have knowledge of how the likely supply chain will be put together to deliver the intended outcomes, and should reflect this in its contracting arrangements with primes.

The role of the prime contractor⁹

This review has heard mixed reports about the role of the prime provider in contract negotiation. We have heard some concerns that prime providers have not negotiated too strenuously with the commissioner over their own contract terms in the expectation that these terms will be stepped down to its supply chain. As the previous chapter has outlined, we have certainly seen evidence of unfavourable terms being passed from head contracts to subcontracts.

A more constructive approach for a prime contractor in contract negotiations may be to engage proactively with the commissioner to ensure it only accepts obligations that can be met by its supply chain members, structuring these agreements proportionately. This would demonstrate the prime contractor as an entity managing service provision across a diverse supply chain in a sustainable way.

There is evidence that some prime contractors are recognising the value in developing long term partnerships with supply chain members. These can prove more effective in delivering contracts and more persuasive when bidding for further work. It leads to less disruption in delivery of individual contracts and less work required in putting proposals together for future contracts. However, in some cases, service providers and prime contractors have had good working relationships which have developed operationally; yet when a new contract has been commissioned, the prime has brought in its commercial team to negotiate it. The team does not have the relationship with the service provider and the benefits of that relationship; the continuity and local knowledge, have sometimes been lost unnecessarily. Parties, having made the effort to develop such relationships, should be mindful of this possibility and seek to avoid undermining them in this manner.

In general, the evidence we found suggests that VCSE organisations have been more inclined than those in the private sector, where they have themselves been engaging other organisations as subcontractors, to reflect the size and nature of those organisations in their contractual arrangements; using slim service level agreements dealing with the essential features relating to the service in question, rather than seeking to impose all the terms appearing in their own contract.

⁹ NCVO, alongside Big Society Capital and others, is currently looking at standards for managing prime and subcontractor relationships. This work will be ongoing through 2013 and 2014.

Management and implementation of PbR contracts

Here we consider the experience of VCSE organisations delivering PbR contracts currently and, in identifying examples of good and bad practices, offer recommendations around the successful management and implementation of PbR contracts.

The need to review contract terms in light of experience

An encouraging sign is that in many cases, both commissioners and prime contractors have shown a degree of flexibility in the management of PbR contracts. They have recognised where they are not working in practice and have been prepared to revisit elements of the contract and to amend them to fit more closely with the experience on the ground. This has occurred as a matter of expediency.

Particularly where the contract is genuinely attempting to introduce innovative practice, there is an argument for introducing a contractual mechanism to formalise this flexibility. Indeed, this is a feature of the Cabinet Office template contract. It acknowledges the speculative nature of many of these arrangements where they are doing something different, and that there may be an element of trial and error in making them effective.

Flexibility around application of contract terms¹⁰

Related to this, there has been recognition in practice of a shared interest among the parties in seeing the contract survive. This has led to contracts not always being enforced to the letter. This is sensible in itself, however it does then potentially encourage unhelpful, sub-optimal practices. For example, it may lead VCSE organisations to think it does not matter what the contract says, because the commissioner, or prime, will not enforce it. This is a dangerous assumption to make.

There have already been cases of primes using the strict contract terms to terminate subcontractors where they have decided they would rather take over aspects of a contract themselves. This is more likely to happen, possibly, where a subcontractor is performing successfully in overall terms; but where they may be in technical breach of onerous contract terms.

¹⁰ Guidance on good negotiation practice is available from NCVO at: http://www.ncvo-vol.org.uk/psd/commissioning/relationships_negotiation

Risk management: the role of prime contractors¹¹

More often than not, we were told prime contractors were not, in practice, mitigating risk within contracts to allow effective delivery within supply chain. At worst, they were simply administering the contract, retaining no risks and extracting significant fees for doing so. This is not universal, however, and there is some evidence of primes who are managing their supply chains effectively by selecting the right service to commission for each client from the most appropriate delivery partner.

In many cases, it was felt the primes were attempting to learn the skills needed to manage the contracts as they went along, applying standard techniques for management to very specialised situations. Understandably this produced variable results.

There had been a sense that recently there is an increasing understanding of the mutual interest in addressing flaws in contracts and more evidence of prime contractors working with their supply chain to present a united case to commissioners: where improvements were regarded as necessary for contracts to be workable.

The commissioner's role: contract management

This review has observed a number of challenges in the commissioner's role in contract management.

Some of the contract management processes adopted by commissioners are regarded as intrusive and unhelpful, interfering negatively with service providers' relationships with service users. Examples of this include requiring meetings to be held, or surveys completed, that serve only a contract management function for the commissioner's benefit, offering nothing to the service user themselves.

There are also examples of recording requirements which duplicate in another form information the providers are already compiling, adding to the bureaucratic burden: to serve no purpose other than contractual compliance. A conversation around what is already available, and its suitability for the purpose intended by the commissioner, is a potentially simple way to make a substantive difference on this issue.

Experience from providers has been that commissioners find black box commissioning very difficult to do. It is very different from their usual way of managing contracts and many have tried to continue their old ways of contract management; notwithstanding this may not be appropriate in relation to these contracts.

¹¹ Explanation about relationships and structures in supply chains is available from NCVO at: <http://www.ncvo-vol.org.uk/advice-support/public-service-delivery/consortia-subcontract/subcontracts>

As has been described previously, flexibility around strict implementation of contract terms was regarded positively; although the motivations for this were not felt to be necessarily about improving the outcomes.

Conclusion

This report has presented an analysis of PbR contract terms across a range of local and central PbR programmes. Still in its relative infancy across most public service markets, it is unsurprising that there remains much to learn about better contracting processes for PbR.

However, it is noticeable that many of these problems are inherited from previous poor contracting practice. They suggest a fundamental failure to accept as essential the involvement of providers, in particular VCSE providers, at the design, commissioning, and negotiation stages of contracting, and to prioritise the need to be flexible and proportionate to the strengths and requirements of a diverse provider market. These behaviours and values should, by this advanced stage of public service commissioning, be well understood and universally practiced.

For VCSE organisations too, there is an imperative for them to seek to engage with commissioners in advance of procurement, to steer the content of PbR contracts. Where commissioners resist this involvement, it may well be worth VCSE providers considering whether they would want to bid for such contracts when they are released.

We agree with the most often raised complaint voiced by our provider interviewees: that PbR must only be implemented when it really is known to be the most appropriate mechanism to secure the commissioner's clearly articulated goals. Notably, reducing PbR to purely changing the payment terms within contracts, to shift risk away from the commissioner, will not deliver on its potential to stimulate service innovation and deliver quality outcomes.

We are still in a period of learning and piloting for PbR. The contractual agreements between PbR parties should not merely recognise the inherent risks to developing PbR programmes, but should also seek to create transparent relationships in which learning can be developed, discussed, and shared. Structuring and delivering effective PbR contracts requires considerable collaboration, skill and effort: getting it right should be a matter of pride for all parties.

Appendix: Check-list for commissioners considering PbR

From the research in this review, we have compiled a check list of questions that commissioners should consider before commissioning a service through PbR. Answering these questions will help commissioners decide whether PbR is a suitable approach for the service and, if so, how to develop this approach most effectively. Conversely, understanding whether, and to what extent, a commissioner has conducted this exercise may go a long way to informing VCSE sector providers about how well prepared the commissioner is to undertake an effective PbR project: and whether they wish to be a part of it.

- **What is it that the commissioner is buying?**
 - Is it more of the same service?
 - Is it about achieving improved performance of the same service and / or the same service at a lower cost?
 - Is it about addressing existing problems or preventing future ones?
 - Is it about stimulating innovation?

- **What is the motivation for the commissioner?**
 - Is it about improving the lives of service users and those in their communities?
 - Is it about reducing the financial and / or social burden on the state in the medium term?
 - Or the cost to the state in the short term?
 - Is it about stimulating innovation? If so, by whom?

- **How (if at all) will a PbR approach help achieve that aim?**
 - Are these circumstances in which it should be possible to identify a direct relationship between the activities of the provider and the outcomes?
 - Are these circumstances in which it may be appropriate to give the provider a completely free rein in how it seeks to deliver the outcomes?

- **How may this commissioning process and this contract be structured to achieve that aim?**
 - Will consultation help identify appropriate targets and with whom?
 - Can the contract be structured so that it supports achievement of the targets and doesn't create its own bureaucratic burden?
 - Can the contract encourage the parties to focus on their common aims?
 - Can the contract reflect appropriate incentives for the parties?

- **How may this contract fit into the wider picture of services currently commissioned for this client group?**
 - Are there already PbR contracts in place or imminent that may restrict the ability of providers to contract yet further on this basis?
 - Are there contracts in place or under consideration that are driving particular behaviours that may not be compatible with what is proposed here?
 - Is it possible to build upon what already exists in this regard?

- **Does the commissioner have a wider responsibility beyond securing value for money in relation to this service, or these outcomes?**

Should the commissioner be concerned with nurturing diversity of provision in the market for these services?

Should the commissioner be concerned with the potential impact of this service provision on other public bodies?

Should the commissioner be concerned with the potential impact of this contract beyond its own term?

Rigorous engagement with these questions, before embarking on the commissioning process, may go a long way to addressing some of the problems experienced to date with PbR contracts which have been outlined in this review.