

November 5, 2018

TO: UK PUBLIC CONTRACTING AUTHORITY COMMISSIONERS & LEGAL TEAMS

RE: SIB CONTRACT FORMATION: ONE MAJOR BARRIER & FIVE POTENTIAL HURDLES

This short memo is prepared for commissioners and legal teams in public contracting authorities, who are developing Social Impact Bonds (SIBs). At the University of Oxford's Government Outcomes Lab (GO Lab), we have observed one major barrier and five potential hurdles that can prevent a SIB contract from being executed if not resolved:

Major barrier: Legal team engaged too late in the process.

Five potential hurdles:

1. **Inappropriate standard payment terms;**
2. **Disagreement on minimum and maximum referral rates;**
3. **No contractor protection in case of authority termination;**
4. **Inappropriate monitoring terms; and**
5. **Lack of flexibility for changes.**

This memo makes extensive reference to the UK Government's SIB Template Contract and SIB Template Contract Guidance.¹ The SIB Template Contract provides terms that are designed to complement some key schedules, including Schedule 1 *Authority Requirements and Obligations* (which includes the outcomes specification), Schedule 2 *Payment Schedule* and Schedule 8 *Management Information*. These schedules are designed to be the essential "levers" of the SIB and are blank slates to be customised to a particular project. However, the main issue we have observed is that late addition of the contracting authority's standard terms can impact the financial model underlying the tender. An authority's legal team needs time to ensure that the schedules and contract terms operate together effectively.

This memo presents the "major barrier" followed by a discussion of each "potential blocker." Preventive or remedial suggestions are offered for each. The memo concludes with reference to additional resources and a call to action: the GO Lab requests copies of executed SIB contracts, redacted as might be necessary, so that we can expand this resource and improve our technical guidance to contracting authorities and other actors. We hope to make it easier to complete the blank schedules and reduce SIB transaction costs in future.

Major blocker: legal team engaged too late in the process

Suggestion(s): Involve contracting authority lawyers (and procurement professionals) early in the process, especially in preliminary market consultations and decisions around outcomes specification, the

¹ The UK Government's SIB general guidance, SIB Template Contract, and SIB Template Contract Guidance are available at <https://www.gov.uk/guidance/social-impact-bonds#available-support>.

payment schedule and sharing of information between parties. Including contract terms with the procurement specification documents helps bidders develop their financial model.

Commissioners should involve their legal team throughout the design of a SIB or outcome based contract. *It can be fatal to proceed without legal team involvement and then to engage them at the end of the process to attach standard contract terms and conditions.* Legal professionals need time to provide a proper standard of service to their authority and cannot allow their independence to be compromised. Potential bidders need to understand contract terms early so the potential SIB partners can develop a financial model based on the risks and timelines associated with the eventual contract and submit a tender on this basis.

Behind the authority's potential contractor is a team of partners with relationships and financing structured around the contract. Resetting the relationships and financing may be very difficult or impossible. SIBs are a partnership with non-standard actors, specifications and payments and information exchanges during performance. Payment is made (at least partly) on outcomes achieved, rather than for work performed. The provider usually needs funding to perform the work *before* outcomes are achieved, so this funding is provided by an investor and/or grant funders. Service providers are usually voluntary, community and social enterprise (VCSE) sector organisations receiving funding from charitable foundations and/or social investors to start-up and perform. There may be multiple providers, investors and grant funders involved in a SIB. Sometimes a special purpose vehicle (SPV) is set up by the investor(s) and the SPV then subcontracts the provider. Sometimes the investor and the provider own an SPV together. If authority lawyers are involved too late and need make changes to contract terms *after the bid has been submitted*, the bid pricing may be rendered erroneous and the contractor's ownership structure undermined, making entering the contract impossible.

SIBs are designed to protect the authority from risk by making the authority's payments wholly or partly dependent upon the achievement of specified outcomes. The primary levers for transferring risk from the authority to the contractor are the outcomes specification, the payment schedule and the terms for information-sharing in the course of performance measurement. Often the grant-making foundation or social investor(s) will carry the risks of non-payment and the amount of funding they make available to the service providers is calculated based upon the Service Fees and Outcome Payments.

Problems will probably ensue if the legal team is presented with the SIB levers seemingly locked as if a *fait accompli* and is then asked for a set of standard terms that will not affect these levers. An authority's legal team can more effectively craft a good SIB contract by *first* helping to shape and set the outcomes specification, payment schedule and information-sharing terms *and then* deciding how to wrap the SIB Template Contract and/or other standard terms around these levers. The SIB Template Contract terms and any other standard terms applied will need to be analysed and customized to ensure they complement rather than conflict with the SIB levers. The following five potential hurdles are essentially examples of how contract terms can interact with the SIB levers.

Some authority legal teams charge fees internally and/or may need to seek outside counsel, so the most cost-effective approach should be developed and costs included in the authority budget for developing the SIB.

1. Inappropriate standard payment terms

Suggestion(s): Consider using the UK Government's SIB contract template and focus on how the outcome achievement is to be verified. Avoid adding standard terms and conditions that create new risks of non-payment for outcomes. Alternatively, allow actors to address and/or price-in your standard payment terms by including them in preliminary market consultations, notices and/or specifications.

The SIB Contract has payment provisions which wrap around and complement Schedule 2 *Payment Schedule*.² The clauses anticipate both Service Payments and Outcome Payments.³ Fundamental to a SIB is that Outcomes Payments are made only after and only if the specified outcomes are achieved. The Schedule 2 *Payment Schedule* is blank because there are different approaches to specifying the outcomes, defining the prices to be paid for outcomes and determining that a specified outcome has been achieved (i.e. what triggers payment). The GO Lab offers a technical guide to setting and measuring outcomes and a guide to setting the price of outcomes, both available online at <https://golab.bsg.ox.ac.uk/technical-guides/>. (The SIB Template Contract guidance also suggests a basic model for payment mechanisms and outlines some of the issues in designing them.⁴)

Many standard terms for traditional fee-for-service contracts with inspection, acceptance, and payment are not appropriate for Outcomes Payments. One simple reason is that the amount to be paid will vary depending on the contractor's success in achieving outcomes. Furthermore, if the contracting authority or another public body controls the data for determining whether the outcome has been achieved, then there needs to be a process around mutual access and validation of the data.

Once the specific process of verifying outcome achievement is defined and priced-into the financial model, the subsequent addition of standard terms may introduce new risks of non-payment and change the prices. If standard terms are to be included in the SIB contract, consider including the terms in preliminary market consultations, notices and/or specifications, so that contractors can address them in their tender and/or discussions as appropriate.

The SIB Template Contract clauses provide Service Fee payments on a monthly basis and Outcome Payments within twenty days of invoicing.⁵ Authorities may want to consider whether twenty days is sufficient time to process the Outcome Payment in circumstances where the trigger may rely on a third party evaluation or not be a fixed date in time.

2. Disagreement on minimum and maximum referral rates

Suggestion(s): Include contracting authority budget constraints or minimum and maximum referral rates in the contract procurement documents. Ask contractors for data in preliminary market consultations if necessary. Consider and address early the implications of an authority obligation to meet the minimum or pay anyway.

² SIB Template Contract Clause 13.

³ SIB Template Contract Clause 13.

⁴ SIB Template Contract Guidance, pp 27 - 29.

⁵ SIB Template Contract Clause 13.2

One of the most important aspects to specify in an outcome based contract is the type of people the contractor will be expected to work with. It is important to consider and describe a “qualified” referral, paying attention to the risk of the contractor undertaking so-called “creaming” (only taking easy referrals) and “parking” (diverting attention from more difficult cases after they have been referred).⁶ Criteria for a qualified referral and/or supporting data should be included in the procurement documents.

Linked to, and following on from this issue of the *quality* of referrals, is the *quantity* of the referrals. In many SIBs the Outcome Payment is dependent upon the number of service users worked with by the Contractor. The SIB Template does not provide clauses on the minimum or a maximum number of people that will be served, but this can be included in Schedule 1 *Authority Requirements and Obligations* and/or Schedule 2 *Payment Schedule*.

If *too many* people use the service, the total cost of outcomes generated may be too high for the authority to bear. A maximum total number of service users will help ensure the authority budgets for outcome payments. An alternative way to address this issue is to specify a maximum or ceiling contract value. This information is important for potential contractors to build their financial models.

At the other end of the scale, if *too few* people use the service then the contractor may not be able to cover their mobilization or set-up costs. If generating referrals is to be the contractor’s responsibility, then it may be appropriate to let them carry the risk of too few referrals. However, if the contractor is reliant upon the authority referring eligible users and too few are referred, the contractor (provider or investor) could lose money for reasons beyond their control. Even if it is up to the contractor to drive referrals, they may be concerned that they have insufficient data about the referral numbers or the referral process is unclear. In these circumstances, the authority should consider whether it is appropriate to guarantee a minimum number of eligible referrals, with a guaranteed payment for that minimum number whether or not the referrals are actually made - i.e. “meet the minimum or pay anyway.” This could be done in Schedule 1 or via a termination sum, as described below. Whether or not this appropriate will depend on the circumstances in question.

Making and then operating under an obligation to meet the “minimum or pay anyway” may seem surprising for the authority staff and is not appropriate in all situations. If there is a small number of potential service users then the margin between minimum and maximums may be very narrow. If the margin is too narrow, the authority may too easily fall below the minimum. If maximum or minimum referral rates are to be set, consider including these rates and/or supporting data in market consultations and the contract procurement documents.

One alternative approach may be to explain how the authority will facilitate eligible referrals (which can be done in the Schedule 1 *Authority Requirements and Obligations*), and provide for contractor protections only within the clauses which deal with termination for authority default. A further alternative approach would be to pay the contractor more for referrals up to a certain agreed number. This may give the authority extra value for money where the programme was scaled up,

⁶ For a discussion of approaches to mitigate risks of creaming and parking, see Eleanor Carter and Adam Whitworth, *Creaming and Parking in Quasi-Marketised Welfare-to-Work Schemes: Designed Out Of or Designed In to the UK Work Programme?* J Soc Policy. 2015 Apr; 44(2): 277–296, available at <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4413869/>.

but could also be used to protect the contractor in circumstances where the level of referrals is lower than expected.

3. No contractor protection in case of authority termination

Suggestion(s): Use the termination clauses in the SIB Template Contract, which includes voluntary termination after 24 months with payment to the contractor of an “Authority Default Termination Sum.” If not using these terms, the authority should make cancellation terms explicit as early as possible.

In order to develop their financial model, the contractor needs to understand what will be paid if the authority makes a voluntary termination or defaults. This is because the contractor may not have had the chance to achieve enough outcomes at the point of termination to cover their costs up to that point and the termination will deny them the chance to achieve more outcomes in future and recoup their upfront costs.

One way to work out how much to pay a contractor on termination is to include a mechanism to estimate what outcome payments would have been made if the contract had been continued. On one hand, the SIB is premised on the possibility that some or all of the potential outcomes may not be achieved. On the other hand, the contractor has signed up for the opportunity to achieve all the outcomes and receive all potential outcome payments (or at least enough to get back their up-front investment).

The SIB Template Contract strikes a balance by providing a voluntary termination mechanism⁷ with an “Authority Default Termination Sum” calculated on a gross “Minimum Expected Outcomes” amount to be specified.⁸ However, the voluntary termination mechanism allows termination after 18 months of performance following services commencement, and requires at least 6 months’ notice (in other words, voluntary termination is not possible within 24 months under the template). This might give the contractor a chance to achieve some outcomes and give an indication of likely level of performance for the rest of the contract - but whether this is long enough will depend entirely on the payment terms of the particular contract.

Like any contract, the SIB Template Contract also provides a mechanism for contractor termination under certain defined circumstances (for example, bribery, corruption, gifts and fraud),⁹ or following a performance improvement plan.¹⁰

⁷ SIB Template Contract Clause 24.7

⁸ From Clause 1. Definitions: “Authority Default Termination Sum” means an amount which is reasonably determined by the Authority, on the basis of information available to the Authority following consultation with the Contractor and having regard to any representations made by the Contractor (provided that, if the Contractor does not agree with the Authority’s determination the matter shall be determined in accordance with the Dispute Resolution Procedure), as being equivalent to the amount the Contractor would have received (net of any payments already received under this Agreement) had this Agreement continued until the Expiry Date and the Contractor had met [the Minimum Expected Outcomes] less the additional costs that the Contractor would have incurred in providing the Services from the Termination Date to the Operational Period End Date (for the avoidance of doubt without adjusting either the Outcomes Payments or the additional costs for inflation).

⁹ SIB Template Contract Clause 23.

¹⁰ SIB Template Contract Clause 24.1 (*Performance Improvement Plan*), 24.2,3 (Termination on Contractor Default), 24.4 (Rectification).

4. Inappropriate standard monitoring terms

Suggestion(s): Start with the UK Government's SIB Template Contract and avoid adding standard terms that create an additional administrative burden or operational costs. Update the terms to include General Data Protection Regulation (GDPR) requirements as appropriate.

Proponents of SIB's often argue that they promote innovation by bringing private sector management approaches to public sector challenges, and that they enable the contractor to have greater flexibility to problem-solve during delivery. Therefore, typical monitoring requirements based on inputs or service quality measures may not be appropriate in an outcome-based contract. Nonetheless, the authority still has obligations to protect service users and accountability to taxpayers.

The SIB Template Contract seeks to strike a balance with clauses on monitoring¹¹ and information¹² and audits¹³ that complement Schedule 8 *Management Information* and Schedule 2 *Data Sharing Policy*. The clauses allow an authority to inspect the contractor three times a year, or more times if required by statutory duty or under a performance improvement plan. Additionally, the authority can audit the contractor twice a year. Schedule 8 *Management Information* is a blank template for detailing the weekly, monthly, and annual data requirements, which should reflect those in the requirements and tender. Schedule 2 *Data Sharing Policy* is also a blank template. There will be a heightened focus on management information and data sharing if these data are used to determine outcome achievement and outcome payments. Adding additional monitoring requirements may increase contractor costs or constrain the contractor's flexibility during delivery.

The SIB Template Contract Clause 10 and Schedule 1 *Authority Requirements and Obligations* are designed to clarify authority obligations during the mobilization (set-up) and performance of the contract. The authority is not to do anything that may jeopardise the ability of the contractor to perform the service or achieve the outcomes.¹⁴ However, the template also provides that "Nothing in this clause 10 shall fetter or constrain the Authority's discretion in the carrying out of its statutory functions."¹⁵

Note that the current version of the SIB Template Contract pre-dates the General Data Protection Regulation (GDPR) requirements under the Data Protection Act 2018, so standard clauses on GDPR would be appropriate.¹⁶ The SIB Template Contract Data Protection provisions,¹⁷ Schedule 2 *Data Sharing Policy* and Schedule 10 *The Caldicott Principles* should be replaced or updated to reflect GDPR.

¹¹ SIB Template Contract Clause 12.2.

¹² SIB Template Contract Clause 12.3.

¹³ SIB Template Contract Clause 12.4.

¹⁴ SIB Template Contract Clause 10.2.

¹⁵ SIB Template Contract Clause 10.3.

¹⁶ See UK Government's GDPR guidance available at <https://www.gov.uk/government/publications/guide-to-the-general-data-protection-regulation>.

¹⁷ SIB Template Contract Clause 15.

5. Lack of flexibility for changes

Suggestion(s): Maintain contract flexibility and avoid re-procurement by using the change provisions and change procedure in the SIB Template Contract.

Whilst it can feel counter-intuitive, you should not expect to have nailed down everything at point of contract signing. SIBs are a new way to address complex social issues so it may be reasonable to expect some changes to the contract during performance, especially adjustments to Schedule 1 *Authority Requirements and Obligations*, Schedule 2 *Payment Schedule* and Schedule 8 *Management Information*. (These schedules are referred to as the critical SIB “levers” above.) The SIB Contract provides change clauses wrapped around and complimentary to Schedule 6 *Change Procedure*. Unlike some of the other schedules, a detailed change process is offered. The SIB Template Contract change provisions are designed to be consistent with the Public Contracts Regulations (2015) and to avoid re-procurement.¹⁸

The SIB Template Contract change provisions require the agreement of both parties.¹⁹ The template also provides for a meeting every three months to review the performance and progress in which the parties should consider amendments to the agreement that would not have “a material adverse effect on the Parties, the Investor or the Service Users.”²⁰ Finally, the template includes the presentation of a financial proposal for the requested change to the Authority, “for review and testing to ensure that this presents value for money and is affordable.”²¹

Conclusion

As noted throughout this memo, most of these barriers and hurdles can be addressed by involving the authority’s legal team in setting the critical SIB levers, utilizing the SIB Contract Template terms, and avoiding the addition of further standard terms that would undermine the viability of the contract for a potential contractor.

The SIB Template Contract provides terms that wrap around and complement key schedule documents that are blank. These key schedule documents - Schedule 1 *Authority Requirements and Obligations*, Schedule 2 *Payment Schedule*, and Schedule 8 *Management Information* -- contain the key levers of the SIB. The authority legal team needs time and resources to ensure that the schedules and contract terms are complementary. This should be done before the tender process so that bids can be developed based on both the schedules and contract terms. Outside legal

¹⁸ Public Contract Regulations 2015 regulation 72 (1) provides: “Contracts and framework agreements may be modified without a new procurement procedure in accordance with this Part in any of the following cases: (a) where the modifications, irrespective of their monetary value, have been provided for in the initial procurement documents in clear, precise and unequivocal review clauses, which may include price revision clauses or options, provided that such clauses— (i)state the scope and nature of possible modifications or options as well as the conditions under which they may be used, and (ii)do not provide for modifications or options that would alter the overall nature of the contract or the framework agreement.” Regulation 72 is available at <http://www.legislation.gov.uk/ukxi/2015/102/regulation/72/made>.

¹⁹ SIB Contract Template Clauses 12.1.5.,14.2.3, and 14.3.

²⁰ SIB Contract Template Clause 12.1.

²¹ SIB Template Contract Clause 14.2.

assistance may be required. To assist all parties, additional GO Lab resources include technical guides on Setting and Measuring Outcomes, Pricing Outcomes and Procurement.²²

To help reduce transaction costs of future SIB's, please consider sharing the actual terms of your executed SIB contract(s), redacted as might be necessary, so that the GO Lab can expand this resource to provide other commissioners and legal teams with additional templates and samples.

The GO Lab hopes this resource is helpful and welcomes your feedback.

Please send comments to the team at golab@bsg.ox.ac.uk.

About the author & acknowledgements

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²² GO Lab Technical Guides are available online at <https://golab.bsg.ox.ac.uk/technical-guides/>.