National Audit Office

Report
by the National Audit Office

Cross-government

Payment by results: analytical framework for decision-makers

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Cross-government

Payment by results: analytical framework for decision-makers

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Payment by results: analytical framework for decision-makers

Summary

1 Payment by results (PbR) is a way of delivering services where all or part of the payment is contingent on achieving specified outcomes. In public service delivery, it is common to pay for inputs or activities (sometimes called 'fee for service'), but in recent years a number of high profile programmes have adopted PbR. These include the Work Programme (DWP), the Troubled Families programmes (DWP, DCLG) and Transforming Rehabilitation (MoJ).

2 This toolkit draws on past NAO work on PbR schemes and presents:

- Claimed benefits of PbR.
- Structure of PbR schemes.
- Features of public services to which PbR is best suited.
- Risks and challenges of using PbR.
- Framework of questions for commissioners to consider at selection, design, implementation and evaluation stages.

Claimed benefits of PbR

3 Supporters of PbR claim it offers a number of benefits over other delivery methods, which may or may not be delivered in practice:

a **Outcomes focus:** PbR directs providers to focus on achieving outcomes. This is attractive to policymakers as it shifts to providers the responsibility for determining which inputs or outputs will lead to the desired outcomes.

b **Innovation:** proponents argue that, by specifying 'what' needs to be achieved rather than 'how', PbR gives greater freedom to providers, which encourages innovation.

c **Cost-effectiveness:** all or some of the payment to providers is contingent on the outcomes they achieve, which reduces the amount of public money spent on ineffective activity.

d **Risk transfer:** PbR arrangements transfer financial risk to providers, who put in upfront financial investment to deliver services with no or limited guaranteed reward if they fail to achieve outcomes.

e **Accountability:** PbR schemes can clarify accountabilities as they make it clear that delivery of specified outcomes is the responsibility of providers.

f **User responsiveness:** PbR arrangements can increase responsiveness to service users' needs, especially if they involve more innovative service delivery or specialist, local-level organisations with a good understanding of users' needs.

Structure of PbR schemes

4 Our work on PbR schemes to date shows there are significant differences in the ways PbR is applied in public service delivery. While the principle of paying for outcomes is the distinctive feature of all PbR schemes, PbR schemes can vary in terms of:

- The proportion of payment that is 'pure' PbR (as opposed to upfront fees eg attachment fees);
- Type of providers used (providers can be other public sector bodies, private sector businesses, or third sector organisations); and
- Nature of outcomes that trigger payments (eg whether payment is related to individual service users, or wider performance targets).

Features of public services to which PbR is best suited

5 The government has not publicly stated the features of public services to which it thinks PbR is best suited. Based on government's experience to date, we have identified the features that we believe make a public service more suited to PbR (**Figure 1** overleaf).

6 In most cases, the policy environment is unlikely to have all of the features set out in Figure 1. This does not necessarily mean that it is impossible to use PbR, but commissioners will need to be aware of the additional challenges this may create and which they will need to manage through the design and implementation of their PbR scheme. For example, where there is little or no data available to set a performance baseline using a smaller 'pure' PbR element may be appropriate.

Figure 1
Features of services suited to PbR

Service feature	Why it matters
Clear overall objectives, capable of being translated into a defined set of **measurable outcomes**	Well-defined, measurable outcomes make transparent the extent of the provider's success, enabling commissioners to monitor the programme and calculate payments due.
Clearly **identifiable cohort/population**	Before the scheme starts commissioners need to specify which individuals they are targeting, so they can track the impact of the intervention.
Ability to clearly **attribute** outcomes to provider interventions	Commissioners need to be sure they are rewarding providers for their genuine contribution to desired outcomes. If external factors such as economic conditions are largely responsible for changes in outcomes, PbR may not be appropriate.
Data available to set **baseline**	To show the impact of the scheme and set effective financial incentives, commissioners need to determine a clear baseline of performance before providers start work.
An appropriate **counterfactual** can be constructed	To determine the effectiveness of the scheme, commissioners need a clear counterfactual to confirm it is the intervention that is driving improvements rather than exogenous factors (eg improvements in the economy).
Services are non-essential and **underperformance or failure can be tolerated**	Commissioners are likely to want closer control than PbR allows of essential services where failure could have dire consequences for public safety or the commissioner's reputation.
Providers exist who are prepared to take the contract at the price and risk	Commissioners will not be able to let the contract if providers do not bid.
Providers are likely to **respond to financial incentives**	If providers are not motivated by financial incentives, commissioners should question the appropriateness of PbR as a mechanism for delivering the service.
Sufficient **evidence exists about what works** to enable providers to estimate costs of delivering services	If there is no clear evidence about the activities that are effective in achieving outcomes, providers may be unable to estimate the costs to them of seeking to achieve outcomes, and commissioners will find it harder to price the contract.
Relatively short gap between provider intervention and evidence of outcome	PbR will be less attractive to providers if there is a long gap between the intervention (which requires upfront investment from the provider) and payment for a successful outcome. Providers may consequently prefer a higher fee for service and a lower PbR element if the gap is long.

Source: National Audit Office

Risks and challenges

7 Commissioners also need to be aware of risks and challenges associated with using PbR, which include:

a **Poorly defined outcomes:** if outcomes are poorly defined providers and commissioners will be unable to measure the impact of interventions. Alternatively commissioners may pay for interventions which do not contribute to their overarching objectives.

b **Setting payment levels:** providers may be reluctant to bid for some schemes if they perceive that payment levels inadequately reflect the cost and risk to them of taking on the contract.

c **Perverse incentives:** providers may prioritise those service users who are 'easier to help' since less effort and expense are required to help them achieve the desired outcomes and hence receive payment.

d **Unsustainable results:** providers may focus on short-term activities to trigger payments, if they have no incentive to ensure that results are sustainable.

e **Retained risk:** PbR does not enable commissioners to transfer all risk. Public criticism about service quality or the methods used by providers can negatively reflect on a commissioner's reputation.

8 It may be possible to mitigate these challenges through careful scheme design and implementation.

Framework for PbR commissioners

9 PbR schemes are a technically challenging form of contracting, which carry attendant costs and risks. If PbR is applied inappropriately there is a risk that either service quality or value for money may be undermined. We have developed a framework that is intended to guide commissioners who are considering using PbR for public service delivery and help them get the best from the PbR model. **Figure 2** gives an overview of the detailed framework, setting out the high-level themes that commissioners should have in mind at each key stage of PbR commissioning.

10 The full framework is at **Figure 3** on pages 10 to 17 and includes key questions for commissioners to consider at each of the four stages of: selection, design, implementation and evaluation. It also gives suggestions for further sources of guidance on wider commissioning and contract management. The framework focuses only on issues specific to PbR rather than good practice in wider public service commissioning or contracting.

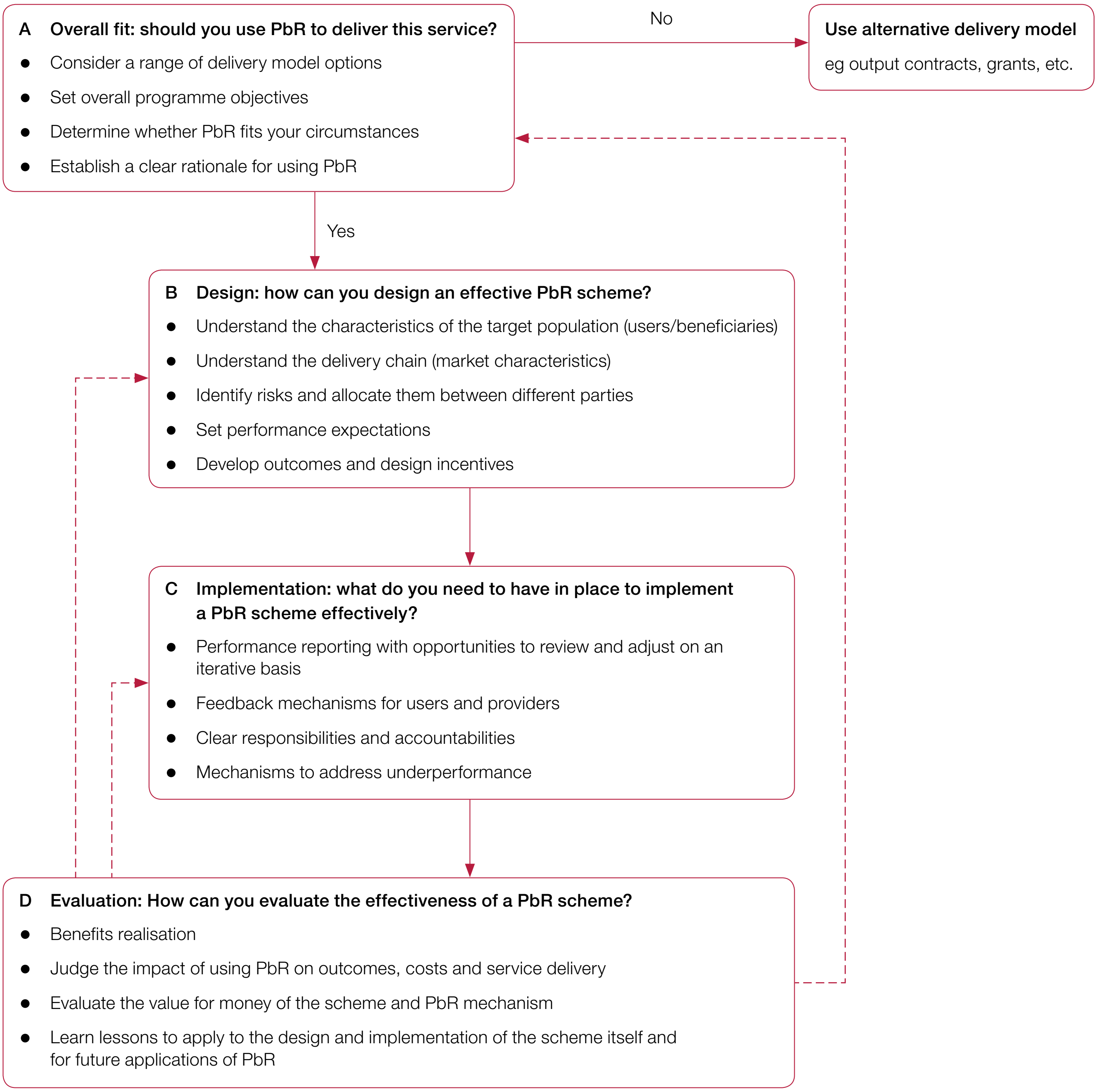
Note on Social Impact Bonds

11 Social Impact Bonds (SIBs) are a source of financing which can help service providers deliver their planned interventions within a PbR scheme. We have not considered SIBs or other forms of social investment in this framework. Commissioners considering a SIB should refer to relevant guidance available at: www.gov.uk/social-impact-bonds.

Figure 2

Framework overview – high level themes commissioners need to consider

Commissioners should consider evaluation needs at the design stage, and feed back learning throughout the scheme life cycle, rather than treating evaluation as a discrete stage at the end of the scheme



Source: National Audit Office

Figure 3

Payment by Results (outcome-based commissioning) Analytical Framework

Best practice aims	Questions for commissioner to consider
A Overall fit: should you use PbR to deliver this service?	
Aim: Commissioners only use PbR to deliver public services where it is the model which offers best value Commissioners' decisions to use PbR are well informed, and based on: • clearly defined programme objectives; • a good understanding of the circumstances in which PbR has worked best in the past (and, conversely, where it has been difficult to use successfully); • clarity about the benefits PbR is intended to bring to the programme at hand; and • knowledge of the whole-life costs and risks associated with using PbR, and the extent to which scheme design will be able to mitigate these.	Considering model options 1 Have you considered a **range of contracting models** which you might use to deliver your objectives? eg have you considered the benefits, whole life costs and risks of delivering the service in-house or through 'fee for service' contracting? 2 Are you clear about the basis for **selecting the model** to be used (eg best value alone, or best value plus social value?) • If there is an overriding **strategic reason** for using a particular model such as PbR (eg a policy decision to encourage innovation, or a desire to gather data on the use of PbR), have you explicitly acknowledged this in the business case? Overall programme objectives 3 Have you specified the **overall objective** you are seeking to achieve? (eg getting more people into work, or reducing re-offending) 4 Is your objective capable of being translated into **measurable outcomes**? • If not, can you construct a reasonable proxy (or proxies)? 5 Are there **additional objectives** or policies that you need to take into account when designing this scheme (eg pursuing a commitment to work with third sector providers)? Whether PbR 'fits' your circumstances? 6 Has PbR been used before to deliver similar objectives to yours? If so, have you identified the **lessons** from applying PbR to the service at hand? 7 Have you considered the extent to which your service meets the **'features of public services to which PbR is best suited'**? (Figure 1) 8 Where your service does not have the features which suggest a good fit with PbR, do you understand the **risks** of using PbR to deliver this service and how to mitigate them? 9 Would using PbR fall within the established **risk appetite** for your programme? (financial, delivery and reputational) 10 Would you be able to **pilot** the service or use a **phased roll-out** of the programme to test your approach, particularly if there are many unknowns? 11 Have you considered **early engagement** with potential providers? (eg to understand the viability of your PbR scheme and what viable bids might look like)

Further guidance

Clear rationale

12 Do you have a **clear rationale** to support your choice of PbR to deliver the service?

- Have you identified the **benefits** of using PbR rather than alternative models to deliver the service?
  - Have you quantified the benefits where it is possible to do so?
- Have you identified the **risks** created or increased by using PbR rather than an alternative delivery mechanism?
  - Have you identified ways to mitigate these risks? (eg through scheme design)

13 Have you estimated how PbR will affect your **costs** in terms of commissioning, monitoring (including data validation) and evaluation?

Circumstances to which PbR is best suited

Features of public services to which PbR is best suited – see Figure 1 on page 6.

Project and programme appraisal

For more information on how to appraise proposals before committing funds to a policy, programme or project see HM Treasury guidance:

- *The Green Book* presents the techniques and issues that should be considered when carrying out assessments
- *Public Sector Business Cases Using The Five Case Model: updated guidance (2013)* sets out The Green Book's recommended methodology which provides a step by step guide to the development of business cases, using the Five Case Model.

Both pieces of guidance are available at: www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-government

Social Value Act

The Social Value Act 2012 requires certain public authorities before procuring services to consider how what is being procured might improve the economic, social and environmental well-being of an area and how the authority might secure that improvement in the procurement process itself. The Social Value Act and its explanatory notes are available at:

www.legislation.gov.uk/ukpga/2012/3/contents

Figure 3 *continued*

Payment by Results (outcome-based commissioning) Analytical Framework

Best practice aims	Questions for commissioner to consider
B Design: how can you design an effective PbR scheme?	

Aim: Commissioners develop insight into the operating context before designing their PbR scheme
 	
Commissioners need to:
• develop a good understanding of:
  ◦ users/beneficiaries and their needs; and
  ◦ the delivery chain for the service.
• understand the different risks within the system and how they will be allocated through the delivery chain, ensuring risks retained by the commissioner are within their stated risk appetite for the programme.
	Users/beneficiaries
	
	14 How **homogenous** is the group of users whom you intend to benefit from this scheme?
	  • Are any **subgroups at risk** of being 'parked' or neglected because they are harder to help? Would it be helpful to segregate the user group to reduce this risk?
	
	15 Do you intend the scheme to engage all service users simultaneously or will there be **different cohorts** starting at different times?
	
	The delivery chain
	
	16 Are potential providers operating within a **market** or not? If there is a market:
	  • Is that market **competitive and sustainable**? If not, what steps could you take to address this? (eg financial support to make it easier for smaller providers to bid, workshops to teach commercial skills)
	  • Are there **supply side features** which might prevent the market from working satisfactorily? (eg prime contractors passing on 'harder to help' cases to subcontractors and keeping easier cases for themselves)?
	
	17 If not a market, how will you be sure you are getting **best value**? Would benchmarking or cost modelling help you set the price?
	
	18 Do you understand **who will be involved** in delivering services to users? (eg how prime and subcontractors will be involved and what motivates them)
	
	19 Do you know how providers will **finance** themselves to cover the upfront costs of delivering the service?
	  • Is **social finance** likely to be required to help make the proposition viable to third sector providers? (eg Social Impact Bonds).

Aim: Commissioners have set clear expectations for the performance of the scheme Commissioners need to set expectations of the likely impact of PbR on: • service performance (eg through modelling); and • user outcomes (eg potential for perverse incentives which might adversely affect long-term outcomes).	Setting performance expectations 26 Have your recorded the current level of **baseline performance** before intervention begins? 27 Have you estimated what outcomes would be delivered without provider intervention over the duration of the contract, a.k.a. deadweight or non-intervention rate? 28 Have you **modelled** what you expect to happen to performance if PbR is used? How might this be affected if demand for services changes? 29 How will you measure the **additional impact** of the scheme on user outcomes? (ie what is your counterfactual?) • If a **concurrent control group** (which is preferable) is unavailable, can you use: similar, comparable existing services, historic programmes, or pilot groups as your counterfactual? 30 Have you tested your **underlying assumptions**? (eg through sensitivity testing, discussions with providers)

Further guidance

Risk allocation

20 Have you identified the **different types of risk** and their potential impact on achievement of your objectives? (including financial, reputational, delivery, and economic environment risks)

21 Are you clear about which **risks will be transferred** to providers, and which you will retain as commissioner?

- In particular, consider the risk of needing to step in, in the event of service failure.

22 Is the level of risk that you (as commissioner) retain acceptable, given your overall programme objectives and the programme **risk appetite**?

23 As commissioner, do you have **mitigating actions** in place to manage the risks you retain? (eg reputational risks)

24 Do you understand the **capabilities and risk appetite of the potential providers** (be they large private providers, small private providers, third sector organisations or government bodies)?

25 Are providers **willing and able to take on the risks** (financial and reputational) involved? If not, do you need to offer additional support?

- Are subcontractors willing and able to take on the risks passed to them?

Value for money in public service markets

NAO report: *Delivering public services through markets: principles for achieving value for money*, June 2012. The report outlines ten principles that policymakers and officials need to consider in order to achieve value for money when using markets to deliver public services. The report is available at: www.nao.org.uk/report/delivering-public-services-through-markets-principles-for-achieving-value-for-money-3/

Risk management

NAO report: *Managing risks in government*, June 2011 sets out six principles of risk management. Available at: www.nao.org.uk/report/managing-risks-in-government/

Social Impact Bonds

For more information on Social Impact Bonds (SIBs), please see the following websites:

Social Finance: www.socialfinance.org.uk/services/social-impact-bonds/

Cabinet Office guidance: www.gov.uk/social-impact-bonds

User outcomes

31 How is the introduction of PbR likely to affect the ways in which providers deliver public services?

- Is PbR likely to prompt providers to seek out more **innovative delivery methods**? Or will they be driven to deliver **cost-efficiencies**?

32 Have you considered how providers might try to ‘**game**’ the system?

Modelling methods and techniques

For more information on modelling methods and techniques please go to the Operational Research Society website at: www.theorsociety.com/Pages/ORMethods/ORMethods.aspx

Figure 3 *continued*

Payment by Results (outcome-based commissioning) Analytical Framework

Best practice aims	Questions for commissioner to consider
Aim: Commissioners identify challenging but achievable outcomes on which to base payments, which in turn provide effective incentives for providers Commissioners need to design their PbR mechanism bearing in mind the need: • to translate their objectives into measurable outcomes; • to structure payments to create an appropriate level of incentive for providers, so the highest payments are matched to the 'best' behaviours or outcomes; and • for the mechanism to bear relation to the providers' cost base.	Developing outcomes 33 Are planned outcomes (or proxies) **SMART** – that is, specific, measurable, achievable, relevant, and time-bound? 34 If there is a long **time lag** between the provider intervention and the outcome data becoming available which triggers payment, how might this delay affect the viability of the scheme for providers? • Is it possible to break down the planned outcomes into shorter-term intermediate **milestones** in a way that is distinct from payment by activity? (this may be needed if it is not viable for providers to wait until a long-term outcome is evidenced before receiving payment) Designing incentives 35 Do you understand the **likely whole-life costs to providers** of achieving outcomes? • Do you know which outcomes are more expensive for providers to achieve? (eg longer-term outcomes, harder to help groups) • Are providers' costs affected by the volume of cases? (eg opportunities for economies of scale)
C Implementation: what do you need to have in place to implement a PbR scheme effectively?	
Aim: Commissioners are able to monitor the performance of providers This requires good performance data systems, including mechanisms for independent verification of performance reporting, to: • minimise delays between achievement of results and disbursement of payments; and • identify emerging risks to the scheme, both at individual provider level (eg significant financial problems at one provider that might affect services) but also wider risks which could threaten achievement of overall objectives and mitigate these risks where possible.	Performance reporting 42 Is there an agreed system for **measuring provider performance**? Will this system be in place at the start of the scheme? 43 Is the data for measuring performance **reliable and complete**? Do you understand the limitations of the data? Checks and changes 44 Will you permit **changes to performance metrics** as delivery techniques evolve? 45 How will the accuracy of performance data be **verified or validated**, bearing in mind proportionality? (eg cost to commissioner, burden on provider, validation data already available to you) 46 Is information available to **identify 'underperformance'**? What early warning signs can be monitored? 47 How will you understand what actions/interventions result in over/underperformance?(ie the **drivers of performance**) 48 How will you ensure you have **transparency of the whole delivery chain** (from primes through to the subcontractors engaging directly with users) to prevent primes exploiting subcontractors? (eg open book accounting, the Work Programme's Merlin standard) 49 What is the **minimum level of performance** you will accept from providers? If providers fail to achieve that, will it put your overall objectives at risk, and if so what mitigating action can you take?

36 Are providers likely to avoid working with **harder to help groups** unless those groups attract a higher payment?

37 Do you know at what level you need to **set payment** in order to provide an incentive that positively influences behaviour? (ie how much profit will providers need to balance their financial risk? This may vary by provider.)

38 Is there a need for an **upfront funding element**, such as an attachment fee to encourage smaller providers, in particular, to participate?

39 Where there are gaps in your knowledge of providers' costs, can you use **competitive dialogue** to improve your insight?

40 Do you need to structure payments to ensure that providers work for **sustainable outcomes**, rather than short-term 'quick wins'?

41 Can you test your payment structure with providers to ensure that it does not create **perverse incentives**?

Further guidance

Outcomes

The NAO's successful commissioning toolkit includes a section on identifying outcomes: www.nao.org.uk/successful-commissioning/designing-services/building-outcomes/

Price setting

For further reading on price setting please see NAO report: *Deciding prices in public services markets: principles for value for money*, December 2013, which outlines eight key principles that should help promote value for money when setting prices. The paper is available at: www.nao.org.uk/report/deciding-prices-public-services-markets-principles-value-money/

Feedback

50 Are there **feedback mechanisms** from users so that users' views and experiences are understood both by the provider and you as the commissioner?

51 Where a stated objective of the scheme is to find new ways of working (ie encouraging innovation), are there mechanisms in place to ensure **best practice** can be captured and shared among providers?

A framework for performance information

For further detail on the general principles behind producing high quality performance information please see *Choosing the right FABRIC: A framework for performance information* produced jointly by the National Audit Office, Audit Commission, Cabinet Office, Office for National Statistics and HM Treasury. Available at: www.nao.org.uk/report/choosing-the-right-fabric-3/

Intelligent monitoring

Other useful NAO guidance on intelligent monitoring is available at: www.nao.org.uk/intelligent-monitoring/

Figure 3 *continued*

Payment by Results (outcome-based commissioning) Analytical Framework

Best practice aims	Questions for commissioner to consider
Aim: Commissioners establish clear lines of oversight and accountability in PbR contracts and intervention mechanisms to minimise the impact of provider failure on public services. Commissioners: • ensure all parties are clear about their responsibilities; and • understand what constitutes underperformance and how to address it promptly.	Responsibilities 52 Is there a **clear line of accountability** from providers to the commissioner? 53 Are the **responsibilities** of all parties in the delivery chain clearly defined? (eg in contracts or guidance documents) Addressing underperformance 54 Have you identified how you will monitor **benefits realisation**? (eg ensuring that overall programme objectives are achieved) 55 As commissioner, what **contractual levers** will you have to manage poor performance by individual providers? (eg performance improvement plans, publishing performance results, public commitments by providers) 56 How will you tackle **prolonged underperformance or failure** in one or more providers? • Are there mechanisms to ensure service continuity is not disrupted by provider underperformance? Will your contract enable referrals to be switched from poorer to stronger performers? • Will you have some pre-qualified alternative providers ready to step in promptly, in the event of service failure? • Will you have flexibility in order to vary the contract or terminate if necessary without incurring significant costs? (eg break clauses)
D Evaluation: How can you evaluate the effectiveness of a PbR scheme?	
Aim: Commissioners evaluate how using PbR has improved service delivery and overall value for money Commissioners are mindful of the need to evaluate the effectiveness of PbR schemes from the outset, ensuring that the necessary elements are included at the design stage (eg a baseline and an appropriate counterfactual). Evaluation is used both to make iterative service improvements during the life of a scheme, and to identify lessons learned at the end. This should cover the scheme as a whole, as well as the effectiveness of the PbR mechanism itself.	57 Are you able to judge the **impact of using PbR** on outcomes? Can you identify how it has affected the costs of delivery compared to the estimated costs of an alternative mechanism? 58 Has PbR changed the way that services are provided? If so, how? 59 Have you got sufficient information about costs and performance to be able to **judge value for money** – both of the scheme and of the PbR mechanism?

Further guidance

Contract management

For further reading on good practice in contract management go to: www.nao.org.uk/report/good-practice-contract-management-framework-2-2/

www.gov.uk/government/publications/commercial-capability-contract-management-standards

Use of sanctions and rewards

Other useful reading on the use of sanctions and rewards is available at: www.nao.org.uk/report/the-use-of-sanctions-and-rewards-in-the-public-sector-4/

60 Has your experience of using PbR generated **further evidence** on a) when PbR should be used for public service delivery and/or b) how PbR schemes should be designed?

- Are there lessons to be applied to your own scheme immediately? (iterative service improvement)
- Are there lessons to be shared with other commissioners about the selection and use of PbR in the future?

Evaluation in government

For more guidance on evaluation please see NAO report *Evaluation in government*, December 2013, which examines the coverage, quality, use and resource costs of evaluation activity conducted or commissioned by government departments.

An accompanying review, by the LSE, of 34 evaluations across a range of policy areas identified good practice, weaknesses and recommended improvements. Both reports are available at: www.nao.org.uk/report/evaluation-government/

Designing an evaluation

See HM Treasury's *The Magenta Book* which gives guidance on what to consider when designing an evaluation. Available at: www.gov.uk/government/publications/the-magenta-book

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