Ministry of Justice

Transforming Rehabilitation Programme - Payment Mechanism

Market Feedback and Development Considerations

The Ministry of Justice (the Authority) published an indicative payment mechanism Straw Man for discussion with the market in May 2013. The Authority has received significant feedback on the Straw Man and is working to refine and update the payment mechanism in light of both this feedback and further analysis. This document summarises some of the key points raised and some of the potential refinements that the Authority is considering.

Potential providers should note that this document is intended to continue the Authority’s 'no surprises' approach with the market, and to indicate the direction of travel regarding payment mechanism design and development. This document is not part of the formal competition, and potential providers are strongly advised <u>not</u> to use any information in this document in any modelling of bids.

To preserve the integrity of the competition the Authority will not consult with any potential providers regarding this document, and the Authority accepts no liability for any information within this document that is relied upon by potential providers with regards their participation in the competition.

Further work is now being undertaken on the payment mechanism to ensure that it delivers a robust and equitable payment solution that will incentivise providers to deliver real reductions in reoffending. Details of the updated payment mechanism to be used in the competition will be provided to shortlisted bidders at ITN stage, and this is the only payment mechanism that bidders should rely on.

The Authority would like to take this opportunity to thank everyone who made time to provide feedback on the Straw Man payment mechanism and contribute towards the design of the Transforming Rehabilitation Programme.

What the Straw Man Said	What the Market has said / What further analysis has suggested	What the Authority is now considering
Fee For Service - Volume Measurement *'Providers will bid against a predicted baseline volume range, weighted for sentence type & length.* *Volumes will be measured using a single measurement unit. This single measurement of volume is based on the number of offender starts and comprises differently weighted service requirements. Payment will then be pro-rated over twelve months.* *At the end of each contract year, the fixed price point for the coming year will be determined based on the predicted volume range. This will be agreed with the provider prior to the contract year commencement.'*	A consistent request from the market has been for further detail regarding the calibration of the FFS mechanism, particularly around volume sensitivities, as there has been concern around the potential level of exposure to volume fluctuations outside of a provider's control. For example, concerns have been expressed that if volumes drop this could incur costly downsizing activities for the provider, which is compounded by reductions to the FFS payment. These concerns are likely to translate into providers applying additional risk pricing to their bids, and reducing the opportunity for the Authority to obtain the best value for money.	To provide more certainty around the annual volume projections, the Authority is considering basing volume projections for the coming year on the actual volumes experienced in the prior year, except for a narrow range of situations set out by the Authority e.g. where new services will be commencing. The Authority is considering making a different adjustment to price to reconcile the predicted and actual volume ranges that are achieved in year and the adjustment to the price for changes to the volume range predicted for the following year. Both these adjustments to price would involve a fixed percentage FFS price change (increase or decrease) that is applied for each Annual WAV Tolerance range beyond the baseline. In both cases this would be linked to an estimate of the marginal cost of service delivery. Further work is being done to look at how these percentages may be determined. However, the methodology being considered as a means of calculating this adjustment takes into account: a) In Year - changes to expected direct variable costs eg front line consumables, overtime etc, that are expected to have been incurred 'in year' ie during the prior contract year period; and b) Future Years - changes to the expected direct variable costs (as above) and semi-variable costs, eg staff salaries that are expected to be

		incurred during the coming contract year period.
Fee For Service - Maximum & Minimum Volume Adjustments '*Volume adjustments to the fixed annual price will be applicable for up to a 100% increase in volume relative to the WAV Baseline. For increases in volume beyond 100% contract renegotiation will be triggered.* *Volume adjustments to the fixed annual price will also be applicable for up to a 50% decrease in volumes relative to the WAV Baseline. For decreases in volume beyond 50% contract renegotiation will be triggered*.'	Market feedback has suggested that, even without having full sight of the methodology for calculating volumes, the 100% and 50% figures are too high and low respectively. Such changes would result in economies or diseconomies of scale in delivery of the services that would not be marginal cost adjustment.	The Authority is considering amending the maximum volume increase and maximum volume decrease to 50% and 30% respectively, before negotiation is triggered. Testing of the impact of changes to the maximum and minimum volume levels is continuing to be undertaken using historic data and volume trends.
Learning Curve Discount '*An annual Learning Curve Discount will be applied to help drive continuous improvement. The discount will be set by the MoJ as a % reduction in the FFS for each year of the contract*.'	Market feedback has indicated that while a learning curve discount may be appropriate, providers would prefer to set this level based on their expectations of generating efficiencies and improvements in reducing reoffending over time, rather than having the Authority set a uniform percentage decrease each year. Many potential providers have suggested that they would ordinarily propose learning curve/continuous improvement discounts as part of their overall commercial offering, and that by allowing the annual payments to reflect a more accurate view of their cash flow it is possible to alter the pricing mechanism to be less risk-laden and require less working capital, whilst maintaining the same cost base and the simplicity of a single variable that providers can bid against.	The idea of a learning curve that moves the allocation of the annual affordability cap from FSS payment and to the PbR component was well received. This will result in the FSS component decreasing over time and a larger component of the annual affordability cap being put at risk through the PbR element. The Authority is considering allowing bidders to bid the level of Learning Curve Discount, subject to certain parameters, to allow providers to more appropriately balance their willingness to put funds at risk against their need to cover costs over time. It is expected that this would better reflect the market's expectation of reductions in reoffending and efficiency over the contract term. In addition, this may help bidders to more appropriately plan and manage their cash flow over the contract term, taking into account considerations such as working

		capital requirements.
Binary Hurdle '*to receive any PbR payment, a provider will have to have improved performance on the binary metric to a point of statistical significance within the given CPA, regardless of performance against the frequency metric. This reflects the importance placed on achieving complete desistance from re-offending*.'	Market responses to the straw man have suggested that the binary hurdle will lead to increased perception of risk and therefore higher FFS bids. It has also been suggested that the hurdle will encourage 'cherry picking' and / or 'creaming and parking' of offenders, ie providers are not sufficiently incentivised to work with offenders who have already offended and / or who require sustained and complex interventions throughout their journey towards reform. Responses indicate that the hurdle may encourage these behaviours due to the providers need to focus on and invest in achieving this "hurdle" first, before being able to try and achieve payment for any improvements in frequency.	In the light of market feedback, the Authority is considering a range of options in relation to the binary 'hurdle', including: • Retaining the hurdle in the light of the amended targets (see Binary Measure and Payment Curve section for more details) • Removing the hurdle • Setting the hurdle at the re-offending baseline • Changing the weighting split between binary and frequency • Including a frequency hurdle Further internal testing will be carried out to determine the potential payment and reoffending impacts of the different options.
Binary Measure and Payment Curve *'Statistically significant points (SSPs) will be set that identify the appropriate minimum changes to the re-offending rate that would need to take place before any PbR adjustments are applied to the payment*	Concerns have been raised that the shape of the current payment mechanism curve, where no payments or penalties are made for providers whose measured re-offending rate lies within the SSPs, may offer providers an incentive to allow reoffending to increase slightly and thereby reduce their costs. The market has also expressed concerns that for any	Some minor adjustments to the design of the binary measure payment curve are being considered that could be used to minimise the risks identified by the market and increase the incentives for providers to reduce reoffending, including: • A narrowing of the 'payment gap' around the baseline level of performance by using a 80% confidence

received by the provider. *The payment curve has been designed to incentivise the provider by applying stretch targets beyond a SSP.'*	change to be 'statistically significant', it will likely necessitate a large percentage change in reoffending figures that may be difficult to achieve and / or sustain year on year.	interval to define the gap rather than a 95% confidence interval to determine the size of the range. This increases the chances for providers to achieve the threshold level and receive the PbR payment when they have genuinely impacted on reoffending rates. Similarly, this reduces the incentive for providers to simply reduce costs and not attempt to reduce reoffending as this will lead more quickly to financial penalties. • A narrower gap between the lower statistically significant point and the termination trigger point increases the risk of the Authority exercising its right to terminate the contract for increases in re-offending and therefore minimises the incentive to simply reduce costs and not focus on reducing reoffending. The Authority has published details of historical reoffending rates and SSPs at the 80% and 95% confidence intervals for each CPA within the Transforming Rehabilitation Programme. These can be found on the Competition pages. The above considerations will be subject to further testing.
Frequency Measure *'Measures the rate of offences committed by offenders.* *Statistically significant points (SSPs) will be set that identify the appropriate minimum changes to the re-offending rate that would need to take place before any PbR*	The market response to inclusion of the Frequency Measure within the payment mechanism has been generally positive with responses indicating that this will drive more focus on persistent or prolific offenders. As with the binary measure, concerns have been raised that the shape of the current payment mechanism curve may not sufficiently incentivise reductions in re-offending,	Given the volatility of the frequency measure, the Authority needs to consider what approaches can be taken to ensure that providers are incentivised to deliver reductions in reoffending. Analysis has suggested that increasing the size of the cohort for which frequency reoffending is measured reduces the volatility of the measure.. Therefore the Authority is considering measuring frequency on an

adjustments are applied to the payment received by the provider. *To bring forward timing of PbR payments we have set the mechanism to pay out based on targets for 3 month cohorts.'*	but may incentivise doing the same for less. Analysis has also indicated that this re-offending measure is inherently more volatile than the binary measure, which increases the likelihood that that the correct payments would not be made for underlying changes in the frequency of reoffending. The reason for the volatility in the frequency of re-offending is that a small number of offenders disproportionately influence the measure by committing a high number of re-offences, and therefore a provider may miss out on payment even though they have improved this measure for the majority of the cohort.	annual basis rather than quarterly. Whilst this increases the time lag for receiving payments slightly, it gives providers greater certainty around measuring improvements For similar reasons, measuring frequency on the average number of offences per **re**-offenders in the cohort (rather than all offenders in the cohort) is also being considered. Furthermore, it is currently being considered that rather than adopting the same shape of curve as the binary measure, the shape of the curve should be linear between the affordability cap and the termination trigger point, i.e. no payment gap. The net payment over the contract life should better reflect the underlying change in frequency re-offending rates achieved by a provider. The Linear model, with symmetric pay outs on the up side and penalties on the down side, will also show no bias towards the Government or the contractor, i.e. it will be fair for both parties in the long run as all movements in the frequency measure will be recognised. The above considerations will be subject to further testing.
Foundation Payment *'The time lag to measure PbR outcomes is substantial… and therefore the PbR Foundation Payment is designed to ease the provider's cash flow. The Foundation Payment is set at a level that is the expected payment for achieving the quarterly PbR targets.*	Providers responded broadly positively to the foundation payment in respect of the support it represents to cash flow under a PbR model. However, Providers have also raised concerns that the threat of having payments clawed back will impact upon financial planning and may prompt a risk-averse strategy, with under-investment throughout the supply chain and a lack of improved reoffending outcomes. These outcomes would entirely contradict the very purpose of the	The Authority is therefore considering removing the foundation payment from the payment mechanism and is exploring alternative approaches to mitigating working capital constraints, including the potential to allow bidders to sculpt their FSS payment over the contract term. In addition the authority is considering allowing a window following mobilisation before PbR payments kick in. This would mean that bidders would not need to put any

This will be estimated and paid on a monthly basis, together with the FFS. At the point at which PbR results are finalised, this payment will be clawed back if the quarterly targets have not been achieved.'	Foundation Payment. Further analysis of the potential magnitude of the foundation payment has indicated that it is not in fact necessary to help manage provider cash flow, and may require disproportionate monitoring procedures to ensure value for money.	payment at risk during this early period of the contract, further mitigating cash flow constraints. Following this initial period, bidders would need to put a minimum amount at risk for PbR. However, we are considering allowing bidders to bid the Learning Curve Discount (See section on Learning Curve Discount).
Mobilisation, Transition and Transformation Funding *No mention*	The market has requested further detail regarding potential funding for mobilisation, transition and transformation costs, as this is likely to have a material impact on bidding approach. The market has highlighted that it could potentially incur material restructuring costs in order to achieve a more cost effective solution, and that without further information it is difficult to determine how a sufficient return would be made from any initial restructuring investment.	The Authority recognises the importance of these costs and is currently exploring options that offer providers and the Authority optimal Value for Money for all contracts.