Rehabilitation works:
ensuring Payment by Results
cuts reoffending

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Executive summary

There is widespread agreement between both the parties within the coalition government that there is a need for a rehabilitation revolution. The Green Paper “Breaking the Cycle: Effective Punishment, Rehabilitation and Sentencing of Offenders” (December 2010) states

“Despite record spending and the highest ever prison population we are not delivering what really matters: improved public safety through more effective punishments that reduce the prospect of criminals offending time and time again.”

Numbers in prison have increased from 48,621 in 1994, when the Justice Secretary Kenneth Clarke was last responsible for prisons, to over 85,000 today. Reoffending rates remain stubbornly high with 61 per cent of those released from prison reoffending within a year.

Instead of government deciding the most effective way to reduce reoffending and cut crime the Ministry of Justice is now proposing a much greater role for the private and voluntary sector in devising the most effective solutions to reducing reoffending. As part of this it is proposed that for some offenders providers of rehabilitation services should be paid only to the extent that they are successful in reducing reoffending – Payment by Results (PbR).

Advocates of outcome based commissioning and PbR argue that:

“Outcome commissioning can improve the level of achievement of outcomes of public services in three main ways. It ensures providers focus on the outcomes that are important to users, creates powerful incentives to achieve outcomes and gives
Experience of PbR to date in the UK has been primarily limited to the welfare to work market where success has been varied and limited. Despite this, Payment by Results is increasingly being suggested to be used across a wide range of government policies – not only reducing reoffending but also drug and alcohol treatment and early years intervention. If Payment by Results is to be successful in offender rehabilitation it will require a provider market which is diverse and a commercial framework which ensures that providers are able to generate a commercial return at the same time as the policy offers value for money for government.

Previous policy research on Payment by Results applied to reducing reoffending has tended to focus on the policy and economic case. This paper draws on the commercial experience of the author to assess whether it is realistic to have a PbR regime for reducing reoffending given the commercial requirements of potential providers. It further examines what can be done to ensure a diverse market of providers and what government needs to do to maximise the chances of success.

There has been a number of different approaches proposed to introducing Payment by Results in reducing reoffending. The most developed is the Social Impact Bond currently being piloted at Peterborough. This is an innovative project which could yield valuable information and lessons. However it would be misleading to place excessive reliance on this approach, as there is a danger that government is doing. If government wishes to have a significant impact quickly it cannot rely simply on approaches using Social Impact Bonds. It will need to adopt approaches which are attractive to the ‘commercial market’. It is clear that in the short term a ‘pure’ PbR regime will fail to attract a diverse range of providers willing to provide rehabilitation services on a value for money basis for government.

Payment by Results has been used to the greatest extent hitherto in welfare to work services with Employment Zones, Pathways to Work and Flexible New Deal Phase 1. Key lessons learnt from these programmes which should be taken into account in the design of PbR for reducing reoffending are that:
In order to avoid the risk of ‘parking and creaming’ of clients/offenders it may be necessary to have different payment mechanisms for different types of offenders. Indeed, PbR may not be applicable to all categories of offenders;

In the early days of the programme good information on the past history of clients, the cost and success rate of interventions is likely to be scarce. This means that bidders will face excessive risk in pricing their PbR bids. In these circumstances better value for money will be generated by a phased introduction of Payment by Results. This will enable providers to generate improved information in the first two to three years of the programme;

The working capital requirements of a PbR system will cause problems for Small and Medium Sized Enterprises and the third sector in bidding for contracts. This problem is not necessarily alleviated by use of large prime contractors, who will still seek to pass risk and the working capital requirements down to the SMEs and the voluntary sector providers;

Banks are unlikely to lend to providers to finance the working capital unless they are large with substantial balance sheets as the risks involved are ‘equity’ rather than ‘debt’ risks. Private equity houses are unlikely to provide finance in the absence of better information and a track record.

The Green Paper identifies a wish to encourage a diverse provider base. But the working capital requirements imposed by a pure PbR regime means that there will be an inbuilt bias towards larger well capitalised firms. If the government wishes to foster a diverse provider base there will need to be initially a ‘guaranteed’ element to the payment mechanism to reduce the working capital requirements and/or provision of equity or quasi equity finance to meet these requirements.

PbR has an important role to play in relation to some categories of offenders. However, to seek to move quickly to a full PbR approach risks discrediting the policy by running the risk of failure of providers, poor value for money for the public sector and frustrating the development of a diverse range of providers.
We recommend that:

- There needs to be segmentation of different types of offenders. Treating offenders as a single generic group would raise public policy concerns. Otherwise there is the danger of providers ‘cream skimming and parking’ offenders such that only the easiest to treat are provided for. For some categories of offenders, where rehabilitation tends to require prolonged and repeated treatment (e.g. some offenders with persistent drug related problems) it is unlikely that a 100 per cent outcome based payment mechanism would ever be good value for money;

- There should be a phased introduction of outcome based payment mechanisms over a five year period. Payment should initially be linked at least partially to activity, then to intermediate outcome and then potentially to a full outcome based payment. This will ensure better value for money, provide government with evidence to determine whether costs are genuinely saved and facilitate the development of a wider range of providers;

- The government should facilitate the development of financial products which provide equity or quasi-equity type funding to social enterprises and third sector providers;

- Social enterprise providers could explore working together in a cooperative or cooperatives with a view to acting as Tier One contractors and hence helping to ensure a mixed economy of provision.
1 Introduction

There is widespread agreement between both the parties within the coalition government, that there is a need for a Rehabilitation Revolution. The Green Paper “Breaking the Cycle: Effective Punishment, Rehabilitation and Sentencing of Offenders” (December 2010) states:

“Despite record spending and the highest ever prison population we are not delivering what really matters: improved public safety through more effective punishments that reduce the prospect of criminals offending time and time again.”

Ed Miliband, the new leader of the Labour Party, has also pledged his support to efforts to achieve this. Such unanimity of view has emerged as it is very clear that the current system is not working.

Numbers in prison have increased from 48,621\(^1\) in 1994 when the Justice Secretary Kenneth Clarke was last responsible for prisons to 85,268\(^2\) today with the result that in the UK 153 per 100,000 people are in prison compared to an EU average of 127 and only 90 in Germany.

At the same time reoffending rates are stubbornly high. 61 per cent of those released from prison reoffend within a year. For those who have served sentences of less than a year the figures are even higher. Whilst there are no simple solutions there is strong evidence that certain interventions and help do work. Surveys show that for most offenders having a job and a home are the greatest determinants of them not going back to a life of crime. Hence the success of organisations such as the St Giles

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1 Home Office Prison Statistics 2000, Table 1.4.
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Trust which, by meeting offenders at the prison gate and helping them find a home and a job, have managed to cut reoffending rates by between 10.7 per cent and 17.7 per cent.³

Similarly other interventions, such as the Diamond Initiative, a community based reducing reoffending pilot scheme across six London Boroughs, run by the London Criminal Justice Board, has been shown to reduce reoffending by 15 per cent for the six months following the initiative.⁴

Moreover at a time of severe public expenditure constraints which have seen the Ministry of Justice’s budget cut by 23 per cent in real terms by 2014/15⁵, and the total cost of someone reoffending reaching up to £65,000 for a reconviction and followed by up to £37,500 per year in prison⁶, there is a strong financial case for taking action if more effective measures can be found.

It is with this background that increased focus has been upon outcome based payment mechanisms for rehabilitating offenders.

‘The most radical part of our new approach – what some of my colleagues call the ‘Big Society’ – will involve paying independent organisations by results in reducing reoffending.

Outside bodies would have clear financial incentives to keep offenders away from crime. And success would be measured perhaps by whether they find and keep a job, find housing and so on – whether they become functioning members of society – but above all by whether they are not reconvicted within the first few years of leaving prison.

The intention in opposition was to pay for this new approach through the cash savings it was hoped it would generate for the criminal justice system. In government, we intend to pursue this virtuous circle: reduced reoffending, fewer victims and value for money for the taxpaying public.’

Speech by Justice Secretary Kenneth Clarke at King’s College London; 30 Jun 2010.

⁵ CSR, October 2010, p55.
The Green Paper which devotes a whole chapter to the application of Payment by Results to reducing reoffending states:

“…we will give providers the freedom to innovate to deliver results, paying them according to the outcomes they achieve and opening up the market to diverse new players who bring fresh ideas”.

The 2020 Public Services Trust defines the differences between commissioning by outcomes and commissioning by inputs and outputs as follows:

‘Outcome commissioning is the process by which the state designs and implements a system that incentivises the successful delivery of outcomes. There is some disagreement about the definitions of the terms inputs, outputs and outcomes. This report has adopted the following definitions:

- ** Inputs are the “intervention[s] provided”; for example, an offender is provided with literacy training.
- ** Outputs are the “direct and tangible products from the activity”, such as the offender obtaining a literacy qualification or finding work upon release.
- ** Outcomes are the “changes that occur for stakeholders as a result of the activity”. The offender may, as a result of having a job, not reoffend.’

These will be the definitions which we use in this report. However, payment by outcomes is not just being talked about in relation to reducing reoffending, as it is very much a focus of current attention across a number of policy areas. Over the past few years it has been tried in relation to welfare to work programmes such as Employment Zones, Pathways to Work, Flexible New Deal, and is now being proposed for the Work Programme. The 2020 Public Services Trust Report ‘Better Outcomes’ summarises the benefits as follows:

‘Outcome commissioning can improve the level of achievement of outcomes of public services in three main ways. It ensures providers focus on the outcomes that are important to users, creates powerful incentives to achieve outcomes and gives providers flexibility, incentives to innovate and the ability to personalise services.’
So rather than the public sector commissioning a myriad of interventions (e.g. cognitive behavioural therapy or drug treatment for offenders) designed to help reduce the risk of reoffending, private sector providers should be left to innovate in how services are commissioned and then they will be paid by the outcome – in this case reducing reoffending.

Moreover, whereas currently the services provided are cash constrained, it is argued that if services are outcome based the public sector can in theory be prepared to pay up to the full cost of someone reoffending, so saving the public sector money. This is similar to the argument that paying welfare to work providers to get the unemployed back into work results in savings to the payment of job seekers allowance.

But outcome based payment is not without its critics. David Boyle argues that this is just another fad and falls into the trap that targets fell into of trying to measure everything. He goes further and argues that in fact a regime of outcome based payments is even worse, as it links money to the measurement of outcomes.

‘The successes of the New Labour years (rough sleepers, for example) often happened when they dumped the targets and tackled the most difficult cases first. Payment by Results encourages managers to do it the other way around. It encourages them to tackle the easiest cases first and to leave difficult cases for someone else.

None of this suggests we shouldn’t innovate in the way we commission public services. Quite the reverse, but we need to understand that ‘outcomes’ are extremely complex, because human problems are complex. Pretending they are simple and easily assignable and measurable leads to the difficulties.....

So yes, let’s measure outcomes, but let’s do it accurately and work with the complexity rather than pretending it isn’t there. That means the very last thing we should do is to muddle those measurements up with money.’

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This report seeks to address whether outcome based payment is indeed desirable as a mechanism for reducing reoffending and, if it is desirable, whether it is realistically attainable and in what timescale. There have been a number of reports and policy papers which have addressed this issue in the past and the Green Paper outlines some of the issues and problems in some detail. This report focuses rather less on the long term vision than what is realistically attainable in the short to medium term, given the perspective of the potential service providers – who will be asked to provide the services to reduce reoffending.

In our view all too often insufficient recognition has been given to the fact that the commercial framework set by government when seeking to implement policies will fundamentally affect not only the provider market but also whether the original objectives of the programme can be met. The author, who has frequently been involved in setting such commercial frameworks, as well as bidding into government, has sought to bring this commercial perspective to bear in advising on whether, and how, an outcome based payment mechanism can realistically be implemented in the field of reducing reoffending.

The report considers:

- Current practice and future options for payment models for reducing reoffending;
- Previous experience of Payment by Results in public service provision;
- Lessons for reducing reoffending from use of PbR in welfare to work;
- Challenges for government in designing a payment mechanism;
- The provider market and the availability of finance;
- Conclusions on the design of a successful payment by results mechanism.
Reducing reoffending: current practice and future options

THE CURRENT APPROACH TO REDUCING REOFFENDING

A ‘typical’ offender frequently faces a range of complex and interrelated needs which affect that individual’s ability to successfully reintegrate into the community. For example, 72 per cent of male and 70 per cent of female sentenced prisoners suffer from two or more mental health disorders; 52 per cent of men and 71 per cent of women prisoners have no educational or vocational qualifications; and 66 per cent of male and 55 per cent of female sentenced prisoners have used drugs in the past year.8

Offenders often come from backgrounds of social exclusion and deprivation, poor family history of employment and educational attainment, and a high proportion report having suffered emotional, physical or sexual abuse. They are far more likely than the wider population to have been in care as a child, and are far more likely to have a learning disability or difficulty.

It is against the backdrop of multiple complex and interrelated needs that are linked to offending behaviour that any approach to reducing reoffending must deliver. Services are currently organised along seven pathways set out by NOMS, namely:

1. Accommodation and support
2. Education, training and employment
3. Health

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The pathways are intended to bring an integrated “end-to-end” service to the offender which tackles the specific contributing factors to reoffending. At present, although a question mark has been placed over the future of NOMS following budget cuts to the Ministry of Justice in the Comprehensive Spending Review, there is no indication from the coalition government that the focus on these seven factors in rehabilitation pathways is to alter.

The pathways are interdependent and successful rehabilitation is likely to require the provision of support along several, if not all, of these pathways. For example a failure to change an offender’s attitude, thinking and behaviour is likely to have a significant negative impact upon that offender’s ability to get and keep a job.

Outside of a voluntary or mandatory drug testing regime in prison and the accompanying support from healthcare professionals, a recovering addict may easily relapse or use other types of drugs/alcohol, and beyond completion of a thinking or behaviour course it is difficult to measure emotional and social skills. Low level volume crime such as shoplifting is often linked to the need to obtain funds to buy drugs, while poor self esteem, relationship skills and ability to manage anger and frustration are often cited by offenders and ex-offenders as barriers preventing rehabilitation.

Currently therefore when seeking to change offending behaviour, interventions are targeted according to the seven pathways set out by NOMS and services must be integrated in order to ensure that individuals’ specific needs are tackled effectively.

**OUTCOME BASED PAYMENT IN REDUCING REOFFENDING**

Proposals to use a pure outcome based commissioning and payment for reducing reoffending therefore adopt a more holistic attitude where the design of the approach to reoffending is down to the decision of the provider as how best to achieve success.
Three different models for the introduction of outcome based payment in rehabilitation of offenders have been proposed by previous studies.

The first of these proposals was set out in a 2008 Conservative Party policy document, ‘Prisons with a Purpose’. The model provides that:

- All prisons would be either private prisons or prison and rehabilitation trusts (PRTs), with the exception of the highest security gaols;
- the governor of each prison would have responsibility for the commissioning of rehabilitation services for all of those in his care;
- each private prison/PRT would receive payment for each prisoner in two parts:
  1. a basic tariff to cover the cost of keeping the prisoner, calculated with reference to the contemporary cost of keeping and rehabilitating that prisoner;
  2. a premium if that prisoner did not reoffend within two years of release.

This model was prepared in the context of a radical reform of the power and responsibility of prison governors as well as the reform in the status of most prisons. This was therefore a hybrid payment system which involved some payment for inputs alongside a ‘bonus payment’ if an offender did not reoffend.

The second model is set out in the report by the SMF which proposes a straightforward PbR system with a regional charity or social body acting as the lead contractor, coordinating with the government and commissioning services from other third/private/public sector organisations as the lead contractor saw fit. The system would initially only be applied to prisoners serving sentences of less than twelve months. This is very similar to the proposal of the Social Impact Bond (SIB) prepared by the Young Foundation, developed further by Social Finance, and now being implemented in Peterborough.

Finally, there is the Social Impact Bond model as set out in the reports of the Young Foundation (YF1 and, probably, YF2), in which a special purpose vehicle attracts funding from commercial and social investors. This allows them to fund a
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range of interventions on the basis of a return to the investor if after a given period (usually two years after release) the subject of the rehabilitation efforts has not reoffended. Such an approach is currently being piloted at Peterborough prison (see box).

ISSUES AROUND APPLICATION OF THE PETERBOROUGH SIB TO OUTCOME BASED PAYMENT IN REDUCING REOFFENDING

Understandably the Peterborough Social Impact Bond (SIB) has received considerable attention as it seems to show the way forward in how outcome based payment mechanisms can be applied to reducing reoffending, as well as how the payment mechanism can be financed and a system introduced which enables small private and third sector providers to get involved.

Indeed the SIB project is innovative project which has considerable potential to help make the case for outcome based payment mechanisms, and shows the potential for leveraging in private sector capital. The Justice Secretary Kenneth Clarke has described the pilot as the most radical part of the government’s “Big Society” programme and as “exactly the kind of thing we are after”.

However it would be wrong to think that the SIB is necessarily “the answer”. It is a pilot programme with a number of unique characteristics which means that it has only some more general applicability:

- The Peterborough SIB deals with adult offenders who have served a sentence of less than 12 months and who are therefore not usually subject to probation supervision thereafter. It will not prove the success with more difficult groups, or prove the case for private/voluntary sector providers being able to take a more innovative/holistic approach to interventions than is currently the case, as currently there are no interventions with this group.
- The investors in the project are philanthropic investors rather than fully commercial investors. This means that they have been prepared to accept a lower equity return than would be normal for a fully commercial equity
Case Study: Social Impact Bonds – HMP Peterborough pilot scheme

Social Impact Bonds will be used to rehabilitate prisoners on the scheme. These will be 3,000 short-sentence (less than 12 months) male prisoners expected to be leaving Peterborough over the next six years.

Social Finance plays the role of Social Impact Bond Delivery Agency in this pilot. Social Finance believes that £50 million will be enough to fund a sufficient of rehabilitation to cut the 60 per cent reoffending rate for short-sentence male prisoners by 20 per cent.

There has been upfront funding of £5m, mainly from charitable trusts, which is being used to finance the small charity organisations that would otherwise be unable to participate in the scheme. The voluntary organisations include the Ormiston Trust, the YMCA and the St Giles Trust.

Investors include the Barrow Cadbury Trust, one of the Sainsbury Family Charitable Trusts, the Esmee Fairburn Foundation and the Monument Trust, as well as some individuals.

Funding is used to provide support in prison through education, skills and confidence training, as well as continued support after release.

Success is measured by the number of times an offender is reconvicted within 12 months of release. For the first 1,000 prisoners, success will be measured against a control group, consisting of 10,000 short-sentence male prisoners of similar status in other prisons across the country. After this, groups of prisoners will be compared on a rolling basis.

A payout of £6.25 million of Big Lottery and Ministry of Justice money occurs if a 10 per cent reduction in offending is achieved for the first 1,000 prisoners released. This payout is not expected to occur until the fourth year of the pilot.

After the first 1,000 prisoners are released, the target becomes a 7.5 per cent reduction in reoffending rates for the 3,000 prisoners on the scheme.

Investors can expect a return of 7.5 per cent per annum compound over eight years if reduction targets are met. If reoffending is reduced more than the target, returns will increase subject to a cap on the total payout. If reoffending is not reduced by more than 7.5 per cent, the investors could see no return.
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investor. This is particularly the case given that the information on the likely success in reducing reoffending is extremely speculative (based substantially on evidence from overseas) and is unlikely to be sufficiently strong for a fully commercial investor.

- The size of the equity raised with the SIB is very small compared to the financing requirement for the reducing reoffending market as a whole, or for other areas where outcome based payments are proposed, such as welfare to work. In our judgement, to meet the needs of this market it would be necessary to attract some commercial (or near commercial) equity investment as philanthropic capital would on its own be inadequate.

- The funding of the payments to the social investors is proposed to come primarily from the Big Lottery Fund and to a lesser degree from the Ministry of Justice. It has not therefore been necessary to transfer budget from other parts of government to fund the project.

- The SIB will be over a six year period with a return to investors occurring towards the end of that period. If the government therefore were to intend to introduce a pure outcome based payment mechanism in the short to medium term the results of this pilot would not yet be available.

- The payment mechanism used, comparing the rate of reoffending with a control group of similar offenders elsewhere, whilst dealing with the problem of the influence of exogenous factors on reducing reoffending, could not be used if the scheme were to be rolled out nationwide as by definition there would then not be a control group against which the intervention group could be compared.

Whilst the Social Impact Bond in Peterborough is a very useful pilot of the potential for outcome based payment mechanisms, the fact that it is happening cannot be used as a test for the concept in the short to medium term, and results will not really start to become available until at least year 4. If government wishes to move towards outcome based payment on a broader front over the next 3-5 years it needs to approach the issue in a rather different, though complementary way.
THE GREEN PAPER PROPOSALS ON PAYMENT BY RESULTS

The Green Paper published in December 2010 supports the principle of applying a Payment by Results scheme to reducing reoffending (a more detailed summary is provided in Appendix 1). It proposes that over the next two years a PbR approach should be developed and tested. The government intends to achieve this by: designing the Payments by Results model for reducing reoffending; commissioning at least 6 PbR projects encompassing a significant proportion of the offender population; publishing a comprehensive competition strategy in June 2011; and determining how providers should be paid for outcomes.

The Paper recognises that the design of the PbR model must be carefully considered; this will involve tailoring PbR to different groups of offenders, and in some cases combining commissioning for rehabilitation with sentence delivery. It stresses that the model must also allow for competition among a diverse range of service providers.

To be effective, it is argued that PbR needs to reflect sentence type. Consequently, two broad models will be explored; one directed towards offenders receiving a community sentence, the other covering those sentenced to custody.
In this chapter we summarise the experience of using outcome based and activity based payment mechanisms across the health and employment sectors, highlight some of the issues which have arisen in their implementation and draw lessons from this for the use of outcome based payment for reducing reoffending.

EXPERIENCE OF PBR IN HEALTH SERVICES

The area which is most closely associated with results based payments in public services in the health service is where ‘Payment by Results’ was introduced almost ten years ago. This is in fact a misnomer, in that payment by results in health is actually payment by activity, or input in the terminology outlined in the introduction.

The aim as originally conceived was to increase efficiency and reduce waiting times.\(^9\) Clinicians receive payments for providing treatments, e.g. a payment for each hip replacement undertaken, or for every patient seen by a GP. This has been described as payment by activity as interventions may not represent an outcome, particularly where interventions focus on managing conditions rather than curing, and particularly when an individual’s perception of a positive or negative outcome is subjective.

\(^9\) “The aim of Payment by Results (PbR) is to provide a transparent, rules-based system for paying trusts. It will reward efficiency, support patient choice and diversity and encourage activity for sustainable waiting time reductions. Payment will be linked to activity and adjusted for casemix. Importantly, this system will ensure a fair and consistent basis for hospital funding rather than being reliant principally on historic budgets and the negotiating skills of individual managers”, Department of Health, ‘Reforming NHS Financial Fows’, October 2002.
Despite the focus of the mechanism on increasing efficiency, respondents to a Health Economics Research Unit report to the Department of Health, ‘National Evaluation of Payment by Results’, in November 2007 reported that the NHS was already fairly efficient and as such they did not expect to see further cost reductions through efficiency savings as a consequence of PbR.

The majority of financial and clinical interviewees for the Health Economics Research Unit evaluation of PbR reported that PbR had contributed to a ‘more business like’ attitude among consultants and Trust staff, with greater recognition of the link between their work and the financial consequences for the Trust.

Payment by results in the health service has placed a considerable administrative burden on NHS organisations. Each intervention is assigned a code which aligns to a payment tariff and an organisation must record and submit its codes in order to receive payment for the activity undertaken.

The Health Economics Research Unit evaluation of PbR suggested that it was seen within the NHS as largely a finance management system, with little obvious medical or clinical input. Initially the tariff system used was considered too complex, with concerns that the quality of the cost data underlying the tariff was poor. Clinicians were concerned that the pricing did not reflect the services provided. Primary Care Trusts reported that PbR had dramatically increased their financial risk as their income remained fixed while they had no direct control over the volume of activity.

The experience of the health sector is therefore only of limited relevance to the application of outcome based payment to reducing reoffending, except insofar as the transition to an outcome based payment system involves payment by activity.

**EXPERIENCE OF PAYMENT BY OUTCOME IN WELFARE TO WORK**

The sector where outcome based payments have been used, to the greatest extent hitherto in relation to the provision of public services, is in the area of welfare to work services. Welfare to
Work commenced with a number of pilot projects such as the Employment Zones services in 1998, followed by Pathways to Work for Incapacity Benefit recipients in 2003. The case for use of outcome based payments was then given a major boost by the Freud Report (2007) which underpinned the use of outcome based payment for the Flexible New Deal programme adopted by the Labour government, the first phase of which was let in 2008. The impetus behind the use of such payments received a further boost when Lord Freud became a minister in the new coalition government with the specific remit to introduce his ideas regarding outcome based payment to the Work Programme.

**Employment Zones**

Employment Zones take the form of a prime contractor model, whereby lead providers – the prime contractors – are awarded contracts by the DWP to provide back-to-work services in designated zones. Each zone is classed either single provider, with one contractor chosen to deliver services, or multiple provider, where participants are allocated randomly to one of several contractors.

Employment Zones have a three stage structure. The contractor receives a one-off payment for every mandatory participant who begins stage one, during which the participant forms an employment Action Plan but remains on benefit support. Contractors receive no payments for voluntary participants. An intensive job search lasting up to 26 weeks forms the second stage; over this period the contractor receives a payment equivalent to 21 weeks of the average JSA entitlement in the zone, but takes over responsibility for providing financial support equivalent to benefit payments to participants.

The incentive for the contractor to place participants quickly is an increased share of the 21 week payment. When a participant eventually enters employment the contractor receives a single payment followed by a larger second payment if the job is sustained for 13 weeks. If contractors achieved pre-set yearly targets they are entitled to a share of a yearly £1 million bonus in each zone.

**Pathways to Work**

The Pathways to Work programme takes a similar form, with 11 prime contractors awarded 34 area-based contracts by the DWP to provide employment services for people on incapacity benefit. Although any organisation was able to bid for the Pathways contracts, 9 of the 11
successful providers were private organisations and approximately three quarters of the subcontracting providers were from the third sector.

The prime contractors on the Pathways programme were able to refer participants to their chosen subcontractors, who had no contract with the DWP and who therefore had increased flexibility in their methods of intervention. 70 per cent of provider payment was outcome based, dependent on the volume and durability of job placements achieved, with a monthly service fee over the contract lifetime making up the remaining 30 per cent.

Flexible New Deal

Replacing all previous New Deals in 2008 was the Flexible New Deal. The FND also used a prime contractor model, but the DWP awarded contracts that were both longer and larger than any awarded before in welfare-to-work schemes, and in reduced numbers. The aim of concentrating the provider market was to achieve a reduction in the complexity and cost of administration, but some third sector organisations expressed concern over the potential loss of competition. The payment structure for FND providers was similar to that of Pathways, with a 40 per cent service fee for the first 18 months of the contract, and a 60 per cent split of outcome based payments after 13 and 26 week periods of sustained participant employment.

Although the Pathways scheme reduced the length of claims for incapacity benefits by 5 per cent for participating claimants, the National Audit Office estimates that some 80 per cent of this reduction was a result of changes made to the structure of the benefit system, and not as a result of Pathways. The NAO also found that provider-led Pathways, run by the prime contractors, helped participants into jobs at a similar rate and similar cost – an average of £2,942 per job achieved – to Jobcentre Plus-led Pathways, with the added failing for private providers that Jobcentre Plus performed better at supporting the hardest to help mandatory participants.

The Pathways to Work programme for incapacity benefits was judged unsuccessful, providing poor value for money and an unsustainable contracting model, with one third of prime contractors and two thirds of subcontractors operating at a loss. Employment Zones meanwhile were deemed a reasonable
success, and although contractors were judged to have again struggled with the very hardest to help clients, participants in the zones benefited from increased chances of gaining good quality jobs: 32 per cent of Employment Zone participants were in or had been in full-time work (16 hours or more per week) 20 months after referral to the programme, while in comparative areas under the New Deal 25+ the figure was 24 per cent.

In the next chapter we look at some of the lessons to be learnt from the use of payment by results in welfare to work for its application to reducing reoffending.
4 Lessons for reducing reoffending from the Welfare to Work programmes

SEGMENTATION OF CLIENTS

There has been considerable discussion in the case of welfare to work as to whether there should be segmentation of the client base in order to avoid ‘parking and creaming’, i.e. the practice whereby the easiest to help clients are those where the help is concentrated. This issue cannot be divorced from the payment mechanism adopted.

If there has been competition for contracts based on price (as with Flexible New Deal) then there is a greater risk of this occurring. In the case of Employment Zones government fixed the tariff which increased for those for whom it proved harder to find work. Unless carefully designed this runs the risk of providing a perverse incentive for the provider to delay placing someone in work in order to get a higher tariff later. One way of avoiding this is to segment longitudinally and for a new provider to take on responsibility for the individual when they move to the new higher tariff - although this has the disadvantage that the personal contact between the individual client and the provider is broken.

In the case of reoffending the problem will be rather different. First, if an individual re-offends they will re-enter the criminal justice system and hence the potential for longitudinal segmentation does not arise. Second, there is better information to facilitate segmentation from the OASYS system than there might be from DWP systems. Third, parking and creaming is likely to be less acceptable from a public policy perspective in the case of offenders than it is in the case of the jobless.
At least in the short term the success of welfare to work, particularly in an environment of high unemployment, will be assessed in terms of a reduction in numbers of unemployed rather than necessarily in reduction of the hardest to reach unemployed. However in the case of reoffending it is unlikely to be acceptable in public policy terms that, for example, little help is provided to stop violent sex offenders from reoffending because greater help is being provided to another category of offenders.

**IMPACT OF EXTERNAL FACTORS**

The Flexible New Deal programme encountered difficulties in the course of procurement due both to a sharp rise in claimants and the terms of the contract not being flexible enough to cope with such large changes. There was also a concern that the deterioration in the performance of the economy meant that past performance in getting people back to work would prove to be a poor guide to future performance in very different economic circumstances. As a result the payment mechanism had to be amended over the course of the procurement process.

Whilst economic circumstances do have an impact on levels of crime the effects are more long term and the relationship less clear. However there are other exogenous factors that could have an impact on perceived performance. For example, if police numbers were to be cut by 20% it is to be expected that this would have some impact on the detection rate of reoffending both in absolute terms but also potentially on particular types of offences if police priorities change. A reduction in police numbers might lead to a reduction in the focus on drug offences and so the chances of a prolific drug dealer being detected. Hence a provider who is paid on the basis of reducing reoffending amongst drug dealers might show an apparent improvement in performance, for which it is rewarded, which is not real.

**INFORMATION REQUIREMENTS**

A consistent problem which has caused difficulties for bidders to the Welfare to Work programme has been the poor quality of management information about the costs and success of particular interventions and performance in getting particular groups of individuals back into work.
This has a number of consequences. First, it makes it more difficult for new providers to enter the market due to the relative lack of information compared to incumbents. Second, it makes it very difficult to price bids given that returns will depend critically on an assessment of the likelihood of getting someone back into work.

This in turn has three consequences: first it makes the bids more of a gamble than a realistic assessment of risk and return. This will mean that the more sophisticated bidders will place a substantial premium on their price, reducing the value for money of the programme.

Second, as with any gamble, there will be some big winners and some big losers. Both will harm the credibility of the programme. If bidders ‘gamble’ incorrectly they will be at more risk of failing which will lead to adverse criticism. If their gamble is successful they are likely to make super-profits which will also lead to adverse criticism. It is in neither the public sector nor the private sector’s interests that these circumstances arise.

Third, it will make it more difficult to obtain external finance for providers who wish to participate in the programme, as the business cases which will be needed to attract third party finance, whether equity or debt, are likely to be even more demanding than those required by the board of large corporates. This will therefore mean that there will be a bias against small and medium sized providers and also those who do not have ready access to internal corporate finance such as third sector providers.

Similar issues will arise with respect to providers in respect of reducing reoffending but where the lack of performance information is, if anything, worse than in the case of welfare to work. For example advocates of the application of outcome based payment to reducing reoffending argue that good interventions should be able to secure reductions in reoffending by up to 20 per cent (e.g. see SMF). The evidence for this is based substantially on overseas evidence, rather than UK evidence. Given this dearth of evidence, this is not a figure on which a commercial bidder is likely to place too much reliance in the context of the UK and particularly ought not to be used in order to set targets for cuts in recidivism rates for the purposes of pricing a PbR system.
The general problem of evidence in this area is borne out by the review of rehabilitation treatment studies by Lipsey and Cullen in the *Annual Review of Law and Social Science, 2007*. They highlight the striking variability of the outcome of different treatments stating, ‘one of the most general and striking findings of research on this topic is the great variability of the recidivism effects across different treatments and different studies’.

**THE PRIME CONTRACTOR MODEL**

One of the aims of the Flexible New Deal programme was to introduce a limited number of prime contractors to the supply market. This was in order to reduce dramatically the number of contractors with which DWP had to deal and to pass responsibility for intervention programme design and management to the prime contractors. Additionally, as noted earlier the greater the emphasis on an outcome based payment model the greater the importance of working capital and a strong balance sheet. This is more likely to come from a large contractor who will be only interested in this as a market if the contracts are relatively large. Hence a consequence of the prime contractor model is that small companies and third sector providers are unlikely to be able to operate at the prime contractor level.

This is also likely to be the case in the reducing reoffending market. This is not necessarily a bad thing and already a number of consortia are emerging, such as those between Serco and Turning Point and between Kalyx and the St Giles Trust. government needs to be cognisant that adopting a certain payment mechanism and contracting structure will fundamentally affect how the supplier market is structured. In particular government needs to think actively about provider market development so that it does not develop into a small oligopoly of providers. Otherwise the stated aim in the Green Paper of “ensuring a diverse range of providers can bid for or be involved in payment by results contracts” will not be achieved.

**AVAILABILITY OF FINANCE**

government realised at a relatively early stage that one of the consequences of a purely outcome based payment model in welfare to work was that there would be a substantial working
capital requirement. Providers would incur costs up front but would not receive payment until the unemployed had been placed into work.

Whilst it recognised this requirement it did relatively little to recognise this in the design of the programme. Lessons to be learnt from this for the reducing reoffending market are:

- Considerable care will need to be taken to explain the proposition to the financing market.

- It is important that there is the sort of information available on cost of interventions and performance in reducing reoffending which the potential funders will need in order to assess the business cases being presented to them.

- That proper recognition is taken that, at least in the early stages until good corporate track records have been established in this new market, the sort of risks being transferred will be ‘equity risks’ rather than ‘debt risks’ if a pure outcome based model is adopted. This will both affect the likely funders (private equity rather than banks), but also the return expectations of at least 15-20 per cent, rather than up to 10 per cent, with a consequent effect on the pricing of the service. The cost can be lowered through introducing more ‘debt style characteristics’ either through guaranteed payments and/or through activity/service charges.

**BUDGET TRANSFERABILITY**

In the case of the Welfare to Work programme there has been a big debate about the transferability of budget between Annually Managed Expenditure (AME) and Departmental Expenditure Limit (DEL). The argument is that greater spending on welfare to work services, resulting in people getting back to work, results in a benefit saving. Hence there should be provision for a transfer of the AME savings to increase DEL spending on welfare to work services.

The difficulty is in assessing what the ‘deadweight’ is in respect of those who have gone into work, i.e. the proportion who would have found a job anyway in the absence of the welfare to work
services, but also the extent to which the person who is helped back into work is at the expense of someone else who would otherwise have come off benefit.

Whilst there is not the same AME/DEL issue in respect of reducing reoffending there is an issue with respect to budget transferability. Many of the estimates of the costs of reoffending bring together the costs of prison, probation, court time, police time in calculating the saving made if someone, through the help given does not reoffend.

So, in principle, the Courts Service and other services should be prepared to accept a transfer of their budget to the National Offender Management Service to fund outcome based payment mechanisms because of the resultant reduction in reoffending. Aside from the issue of what the deadweight is (i.e. those who would not have reoffended anyway), there is also the issue as to whether in reality there would be a saving to the Courts Service or whether in fact the service they provide is rationed, and hence they would just tend to fill up the courts with other cases.
5 Challenges for government in devising a payment mechanism

Introducing an outcome based payment mechanism will involve a number of challenges for government. In this chapter we examine each of these in turn.

SEGMENTATION OF OFFENDERS

In Chapter 2 we identified the fact that offenders’ specific needs should be addressed in order to reduce reoffending, and that most offenders will have a particular set of circumstances that are unique to that offender and in Section 4 that as a result it is likely there will need to be some segmentation of offenders, with a different approach applied to each. This is recognised in the Green Paper where it states that “We do not think it is necessarily appropriate to apply a payment by results regime to all offenders”.

Segmentation could be used to identify groups of offenders who would be most suited to a particular set or combination of interventions. For example, offenders could be segmented by their security category, the nature of their offence, length of sentence, a particular mental health or substance misuse diagnosis or special educational needs. Alternatively it may be that the OASYS system could be used either to segment the offender base and/or to ascribe different premia to particular classes of offenders.

The type of offence can affect both the attractiveness of a particular category of offender to a provider, and the avoided costs to the public sector. In the Croydon area, where the Diamond project (a joint police, probation and local authority initiative) deals with offenders – excluding Public and Prolific Offenders (PPOs) – who have served less than 12 months, the
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four main types of offences are theft, common assault, driving whilst disqualified and fraud/forgery.

Most theft offences (including shoplifting) are drug related, and experience shows that effective treatment will take time and considerable cost, as it is necessary to tackle the substance misuse. Whilst treatment may be costly and rehabilitation frequently has to be repeated, associated public sector costs of the offending through frequent court appearances, police time and also time spent in hospital as a result of overdosing etc., are reduced. By contrast common assault (often domestic violence) and driving whilst disqualified are offences where the interventions which help to reduce reoffending are often far less costly and have a quicker impact.

Results based payments cannot be applied to all short-sentence offenders. Fraud and forgery offences in the particular case of Croydon (where the major UK Borders Agency office is based) are particularly high because they are related to forged papers of people who are seeking to remain in this country illegally. Payment by Results would be pointless applied to that particular category of offender.

This demonstrates how a payment mechanism might vary depending on the type of offence/offender. In the case of offenders with drug abuse issues it may be inappropriate and poor value for money for the payment to a provider to be based on them not reoffending, as there may be a long period before the various interventions have an impact. If there were to be a purely outcome based payment the working capital requirements and the risk associated with the payment would be very substantial and would make this mechanism very unattractive to a provider except at very high cost to the public sector.

In this case therefore payment based on reconviction rates for a cohort of offenders may be more appropriate as credit would be given for some success in reducing reoffending even if the individual does not completely desist. Alternatively, payment by activity, for example for drug treatment or for intermediate outcome, e.g. remaining off drugs, might be more appropriate. By contrast it may be much more viable to have an outcome based payment applied to offenders guilty of common assault or driving whilst disqualified.
Public and Prolific Offenders

The example of Public and Prolific Offenders (PPOs) illustrates how enforcement can interact with rehabilitation to affect the reconviction rate, and hence how payment on a simple reoffending rate would not be appropriate. PPOs, who commit burglaries and vehicle crimes (those crimes which are of greatest concern to the public), will be subject to very close monitoring by police and probation, whose success is measured by reconviction rates dropping. However, a potential reason that the reconviction rates for these offenders (who may well have substance misuse and other problems) drop could be that enforcement has increased, resulting in them being put back into prison for breaching their probation. As a result their conviction rate has dropped because they are recalled to prison, not because the provider has had success in their rehabilitation.

The OASYS database has a huge data set available – around 2 million completed OASYS reports – leading to an accurate measure and predictor of the risk of reoffending. In principle this might give confidence to private sector investors, who will be able to price their risk accordingly and have a tool to help them with the decision about what treatment they ought to supply to each offender.

Once an initial assessment has been made and the risk priced, the system can be used to monitor progress and inform commissioning decisions. The system is thus joined up – the suppliers can have key stage assessments for their own purposes, e.g. complete a second OASYS assessment at the point of release to determine what assistance is now needed to support the offender as s/he is released. This model would create a “portfolio effect” which would allow commissioners and providers to maximise the chances of success by targeting interventions more effectively; further refine understanding of the most successful interventions for each group; and importantly, spread the risk.

The OASYS database could also, in principle, be used to avoid creaming/skimming since risk can be assessed for each individual offender and an appropriate premium attached to that offender. This would ensure that there is an incentive exactly calibrated to that offender’s reoffending risk and therefore the amount of resource which ought to be directed towards that offender. However,
excessive personalisation or segmentation of the payment mechanism risks making it unwieldy, costly to administer, with very substantial transaction costs, and more liable to gaming.

Experience of both outsourcing and private finance initiative (PFI) contracts is that it is generally a mistake to make payment mechanisms very complicated. There is often a temptation to seek to make the payment mechanism able to deal with every risk and provide all the appropriate incentives for providers. Hence whilst there are theoretical attractions in a highly personalised approach to a payment mechanism, we would advise strongly against it and recommend that the payment mechanism be as simple as possible.

HOW CAN OUTCOMES BE MEASURED?

The key challenge in developing a successful payment by outcomes model in reducing reoffending is resolving the difficulty in determining the accuracy of the outcome. The burden of proof for any reduction in reoffending falls upon other parts of the criminal justice system – namely the police in detecting crime and on the police and Crown Prosecution Service to prove that an offender has committed a crime.

In a broader economic climate of reduced public spending and police budgetary contractions of at least 4% per annum for the next four years, it may be undesirable for payments for reducing reoffending services to be contingent upon the ability of the police to detect and prosecute crimes. This would effectively reward suppliers for budget cuts in other parts of the public sector, rather than for an actual reduction in reoffending, and as such leaves both the supplier and the system open to criticism.

It is clear that the measurement of outcomes in this case is very different from the case of welfare to work. Generally in the case of welfare to work, the client wishes to register a successful outcome, i.e. getting into work. In the case of reducing reoffending, conviction rates (as used in the case of the Peterborough SIB) are purely a proxy measure of the desired outcome: the offender not reoffending. However the use of conviction rate rather than simply the offender not reoffending has the advantage that it will measure progress in reducing the recidivism of offenders even if they do not desist entirely from crime.
An alternative would be to place a focus on those factors which can more easily be measured, namely the outputs associated with each of the seven reoffending pathways. Each of these pathways underpins offending behaviour and the factors addressed in the pathways are interlinked and indeed in some cases mutually dependent. For example it is likely that an individual’s ability to maintain employment will be severely limited by an alcohol or drug problem, and managing a positive relationship with children and family members will rely on an individual being able to manage emotions and behaviours effectively.

Prior to reaching a stage at which outcomes, i.e. whether or not a person has reoffended, can be measured effectively and with a reasonable level of confidence, the payment mechanism could be related to those interventions which focus on the factors which are likely to cause reoffending behaviours. Addressing these behaviours will reduce the likelihood of reoffending and measuring outputs or intermediate outcomes in these seven pathways could therefore form the critical transition phase of implementation of a payment by outcomes system.

**COMPARISON OF OUTCOMES**

The final issue in relation to how outcomes are assessed is assessing the counterfactual – what would have happened if the intervention had not occurred. As discussed earlier, in the case of the Peterborough Social Impact Bond this will be done through comparing with a control group of offenders of similar characteristics. This would not be possible in the case of a nationwide roll out of an outcome based payment mechanism. The OGRS system, which is part of OASYS, does have a predictor of the risk of reoffending of different types of offenders and offences based on sample actuarial data, from 2002, almost ten years ago. Whilst useful for the purposes to which the OASYS system is currently used (alongside the more dynamic and qualitative measures of risk of reoffending input by probation officers in the OASYS system), it is more questionable as a basis for payment, particularly given the elapsed time, changes in the criminal justice system and economic and social factors in the interim period.
PROVIDING THE INFORMATION BIDDERS NEED

When designing a commercial framework for commissioning a service such as reducing reoffending it is critical to take into account how the provider will assess the business case for bidding for the service.

A key concern for potential providers who are considering bidding for any reducing reoffending services that are paid by outcomes will be what, and how much, information is available to assist with the qualification and tendering process and to price the bid. A provider must be able to determine whether it is worth investing time in producing a tender, and most providers will need to answer the following questions internally prior to qualifying in an opportunity and preparing a tender:

- What is an acceptable margin of risk? The less clearly this can be determined, the greater the risk premium that is likely to be charged.
- What will be the profit margin on the opportunity?
- Will the cash flow be acceptable?
- Is the outcome measurable?
- What is the size of the population? Is a portfolio effect likely?
- What are the TUPE implications of the opportunity?
- Are there public sector pension liabilities associated with the opportunity?

Aside from the normal assessments of margin, cashflow, return on capital, cost of finance and the like; there will be a number of other important factors:

- Is the outcome clearly measurable? Is there a clear definition of reducing reoffending which is not open to interpretation, e.g. should it be reconviction rate or simply whether an individual is reconvicted within one or two years?
- What factors outside the influence of the contractor can affect the outcome? In the case of welfare to work a large increase in unemployment affected the chances of getting people back to work. In reducing reoffending a significant cut in police numbers could affect the chances
of reoffenders being caught, particularly if certain types of offences, e.g. drug offences were de-prioritised.

Can the contractor assess/affect the nature or characteristics of those coming into the process? If the contractor takes responsibility for an offender only once they leave prison then what happens inside the prison will affect the chances of them reoffending. For example, if all literacy and numeracy classes in prison were to be stopped during the period of the contract with the provider, this would adversely affect the chances of an offender being employed and so increase their chance of reoffending.

Can the contractor quantify the risks associated with achieving the outcome? If there is good and reliable data on the success rates of particular interventions as well as risks of reoffending amongst particular types of offenders, then they can ascribe probabilities to the risks being taken on. If not, a substantial premium has to be added.

It is also important to recognise that there will be some types of risk that providers will be unable to take. For example in the Flexible New Deal Phase 1 contracts initially there was no variation in payment irrespective of the number of unemployed people that a contractor had to provide services for. In a situation of rising unemployment this was clearly a risk that was unreasonable for a contractor to take on, and so the commercial framework was varied to introduce payment banding.

Will the provider have control of the interventions? This is a prerequisite if the provider is required to take on risk.

Can the contractor spread the risks? The contractor may be able to spread the risks over a large number of offenders and so derive a ‘portfolio effect’ to reduce the risk overall. We consider this issue in some greater detail in the next chapter as it has implications for the design of the contracting mechanism.
CONTRACT SIZE

The smaller the number of offenders that a provider works with, the more risky it will be to accept an outcome based payment mechanism. Previous studies (SMF and the Young Foundation “Social Impact Investment: The opportunity and challenge of Social Impact Bonds”) have highlighted that this will significantly affect how a Payment by Results scheme should be designed. For example, discussion with Social Finance concerning the Peterborough Social Impact Bond indicates that the cohort size being dealt with in Peterborough is in their view the minimum acceptable size, and that a more ‘commercial’ investor is likely to aim for a larger cohort size. This has a number of implications.

Firstly, it means that the ‘localist’ aims of the Green Paper (“Piloting a local approach to payment by results”) will be constrained by the need for an adequate cohort size, particularly if, as we suggest is advisable, there is segmentation of offenders such that different payment mechanisms, and potentially different providers, are used for different categories of offenders. This seems to be recognised in the Green Paper where the two pilot projects identified are stated as covering Greater Manchester and one covering a number of London Boroughs.

Secondly, the need for a certain size of contract will inevitably limit those providers who are able to bid on a payment by results basis. Normal government procurement guidance on size of contract relative to turnover of company is that generally a single contract should not form more than 25% of the turnover of the contractor. Whilst this would indicate that contractors should have turnover in excess of £10m pa (assuming a contract somewhat larger than the Peterborough contract), the working capital requirements of a pure PbR system would probably require a rather larger provider.

Whilst this would tend towards a prime contracting model for the PbR market this does not necessarily lessen concerns about the financing implications of PbR for small and medium size providers. The evidence from the welfare to work market is that prime contractors are seeking to pass down as much as possible of the outcome risk to Tier 2 and Tier 3 suppliers which therefore still imposes significant working capital requirements on small and third sector providers. This is in contrast to the Social Finance
approach at Peterborough where the SIB investors provide the working capital and take the outcome risk.

QUALITY OF INFORMATION

In some cases the concern about the quality of information which can be provided by NOMS to bidders will be borne out of a degree of ignorance and hence lack of confidence on the part of providers when addressing a new market. As an example, bidders will approach with a high degree of scepticism the data on risk of reoffending contained within OASYS, given that it is based on a study carried out up to ten years ago. Likewise there will be scepticism concerning the degree of confidence about data collected for a different purpose, as a basis on which payments will be made. Hence whilst NOMS may believe that there is data on which providers can base their bids, it may not be of sufficient quality, or perceived quality, for the bidders. Without this level of detailed information from the government, providers will not be able to submit tenders that give the government a reasonable level of certainty in price and quality of services.
6 The supply market

The supply market for providing rehabilitation services for offenders and ex-offenders has traditionally been very diffuse and diverse with a large number of small private and social enterprises providing highly localised services. In this respect the provider market has been very similar to that historically provided in the welfare to work market; there is recognition that many of the services provided need very localised solutions or services designed to reach hard to reach groups.

We provide in the table below a categorisation of the likely supply market in reducing reoffending, drawing on the experience of the Work Programme. Whilst turnover size is only a proxy measure, our conclusion is that there are only 4-5 companies currently in a position to carry out multiple sizeable outcome based reducing reoffending contracts as prime contractors (we have not currently seen any evidence that Capita is interested in this market, though there may be others such as Babcock who are). There is then a group of perhaps 4-5 companies who might be able to take on 1-2 prime contracts but it is very clear that the number of potential prime contractors is very limited.

The nature of the supplier market and its ability to respond to the challenges of the rehabilitation revolution will be a function of a number of factors. Whilst this report is primarily concerned with the desirability and realism of introducing outcome based payment to reducing reoffending, it is important to recognise that there are other factors which will fundamentally affect the supplier market which we touch on first:

- The commissioning approach adopted. There is a potential conflict between the desire to reduce commissioning and service design costs by letting larger contracts to prime contractors who will then manage
sub-contractors (who in many cases will be the existing providers), and a push towards localism which implies more localised commissioning.

- The extent of segmentation of different offender groups. There will also be conflicting pressures in this case. On the one hand some specialist providers may be better able to work with certain groups of offenders but on the other hand, having a large enough number of offenders to spread the outcome based payment risk implies a regional or even national contract.

- The poorer the information provided by the Ministry of Justice, the greater the bias towards incumbent suppliers.

A pure outcome based payment approach will almost inevitably, at least initially, restrict the number of service providers who could act as prime contractors in view of the financing requirements. Experience from Flexible New Deal Phase 1 indicated that there was a relatively small number of companies who were able credibly to act as prime contractors – the largest of which, Serco, is also likely to be a significant player in the reducing reoffending market. Other players who are active in the Welfare to Work market such as A4E, Working Links, Avanta, and Prospects might also be interested in the reducing reoffending market as providers.

However the fact that these suppliers are currently tendering for the Work Programme, which in itself has substantial financing requirements, means that they are unlikely to be able to take a very active part in the reducing reoffending market for the next 2-3 years if a substantially outcome based payment mechanism is used. Likewise with some of the more specialist social enterprises such as St Giles Trust, NACRO etc. who are likely only to have access to debt finance rather than equity finance, it is most unlikely that they would be able to act as prime contractors.

This situation might change if any of these enterprises were able to scale up quickly using external finance. However for the reasons outlined in the next chapter we consider that this is unlikely.
Financial figures refer to the full year 2009, approximate to the nearest million; data for private and voluntary organisations are from financial statements; charity data from the Charity Commission website.
THE FINANCING MARKET

One of the consequences of an outcome based payment mechanism is that there are much more substantial working capital requirements placed upon providers as they have to incur costs before they receive payments for getting the unemployed back into work. As a result, in the Flexible New Deal programme there was initially provision for a 20 per cent up front service fee, with a 80 per cent split of outcome based payment after 13 and 26 week periods of sustained participant employment. This was amended in the course of procurement to a 40:60 split because of the problems which this caused for some providers in financing the programme.

A diverse supplier market would require more providers than just those in the £1billion plus turnover category which have substantial balance sheets and who can therefore provide the funding requirements which a pure outcome based payment mechanism requires.

Our analysis of the market and our discussions with potential suppliers and potential funders highlights the following points:

- Proper recognition should be taken, at least in the early stages until good corporate track records have been established, that the sort of risks being transferred will be ‘equity risks’ rather than ‘debt risks’ if a pure outcome based model is adopted. This will both affect the likely funders – private equity rather than banks – but also the return expectations of 20 per cent plus, rather than up to 10 per cent. This will therefore increase the price of the service. Whilst banks are keen to lend to this market they will only do so if the payment mechanism has greater ‘debt characteristics’ through guaranteed payments, and/or activity/service charges or intermediate outcomes, e.g. getting an offender into housing. Introducing more debt risks would also help to lower the cost of the finance.

- Amongst private equity there is an appetite to become involved in financing the market but considerable suspicion of the role of government as the payment counterparty. In particular there is concern that as government will be the sole funder of the reducing
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reoffending market (just as it has been of the welfare to work market) the nature of the market will be subject to political whim. There is also a concern that 20 per cent plus the return that private equity will be expecting will attract adverse public criticism, as will any failures of suppliers. The early and continued criticism of the returns made in the PFI market was cited as evidence for this concern. In the development of any market there are likely to be substantial ‘winners and losers’ but this is rarely recognised in public commentary.

This issue is exacerbated by the currently relatively poor information available on cost of interventions and their performance in reducing reoffending, which the potential funders will need to assess the business cases being presented to them. This makes assessing likely success or failure more of a gamble than a proper assessment of risk and reward. As a result a significant premium may be placed on the return expected.

Poor quality of information will also provide an inherent advantage to those suppliers who were closest to being incumbent suppliers with a consequent further reluctance to finance new providers.

The Social Impact Bond pilot in Peterborough may in time illustrate the potential for use of outcome based payment mechanisms in reducing reoffending. However we do not consider that its existence fundamentally alters our conclusions that currently there is not external finance available for pure outcome based mechanisms as:

- The finance for the Social Impact Bond is essentially ‘philanthropic venture capital’ and whilst the providers expect to get a return it cannot be judged as fully commercial – particularly given the maximum expected return of 13 per cent.
- It will be some years before it can be properly assessed whether the scheme has been successful.
- The project is relatively small in terms of number of offenders being dealt with and hence the financing requirements are relatively modest.
A move to a substantially outcome based payment mechanism at an early stage would be unwise as it would restrict the market and would be likely to lead to some big winners and losers which could undermine the political and public support for the programme and would lead to poor value for money.
7 Conclusions on the design of a successful outcome based payment mechanism

This paper has provided a commentary on the approach and mechanism for supporting the rehabilitation revolution through outcome based commissioning. We have focused our analysis on how a commercial framework should be established to ensure that there is a more diverse range of providers as desired by the Green Paper and to maximise the chances of success of a Payment by Results regime reducing reoffending. Our judgement is that there will be severe risks in moving immediately to an outcome based payment model and we share the conclusion of the Green Paper that Payment by Results will not be appropriate for all categories of offenders.

First, for certain types of offenders, such as those who have substantial drug misuse problems, the costs and time period required to address the problems are such that an entirely outcome based payment would not be appropriate. This is not to say that an outcome based portion of payment would not be appropriate in time, but we do not consider it would be appropriate for it to be the largest proportion.

Second, currently only a very small number of potential providers would be in a position to provide a purely outcome based payment service and that further time is required to help to foster the development of an active and diverse supplier base. The risks which a pure outcome based payment system would place on suppliers would mean that very few, if any, third sector suppliers could realistically bid and if they did so there would be a high risk of failure and of them being unable to satisfy the contract. In our view a more graduated introduction of an outcome based approach would long term be more beneficial as
it would facilitate the development of a more competitive supply market including mutuals and other third sector providers.

Third, the government needs to establish that there is a value for money case for moving to outcome based payment and must establish mechanisms to prove that savings can be made by reducing costs in the prisons and court services.

Fourth, the availability of information is such that currently poor value for money would be obtained by a pure outcome based system as the risk premium which (even the large scale) providers attached would be excessive and would lead to a high price being levied.

Fifth, further work needs to be carried out on segmentation of the offender base using the OASYS system to try to devise payment mechanisms which can more properly target interventions to particular classes of offenders.

We propose therefore that there should be a discovery or transition phase over a three to five year period. This timescale would allow pilot schemes to be developed and evaluated across a range of offender locations and populations (as is proposed in the Green Paper). This also allows all participants from commissioners to providers to have ‘road tested’ the outcome approach and allows the policy to evolve rather than implementing the process through a big bang transition. Our judgement is that for some categories of offenders it is quite likely that it will never make good economic sense to move to a full outcome based system.

It is proposed that the implementation of a payment by outcomes model for reducing reoffending should take place in three stages, as shown in Figure 1.
In the first phase payments would be made in relation to agreed interventions in line with bids made by providers. Therefore providers would be paid for activities/service provision in a similar form to ‘payment by results’ in the NHS, which is in reality payment by activity. These would be linked to the seven pathways of NOMS.

In the second phase there could be some payment by intermediate outcome, again linked to some or all the seven pathways of NOMS. For example in the case of drug and alcohol treatment, the first phase payment mechanism could be provision of a specific course/treatment. The second phase of payment could be linked to proven success in the individual staying off drugs/alcohol.

The third phase of the transition would be a move to measuring success purely through the individual not reoffending, or through a reduction in the reconviction rate. The transition would not necessarily be a linear move through all the phases of the payment mechanism. For example whilst it may be possible to have an intermediate outcome associated with drugs, alcohol or employment, it may not be possible to have an intermediate outcome associated with children and families or attitude, thinking and behaviour. In these cases therefore one might move straight from payment by activity (Phase 1) to a full Phase 3 payment connected to reducing reoffending.

A transition period would have a number of additional advantages. Firstly it could give the government time to facilitate the development of financial products which provide equity or quasi-equity type funding to social enterprises and third sector providers. Currently government funding of social enterprises administered by the Social Investment Business is primarily either loans or grants. For the reasons outlined in Section 6 on financing we consider that equity finance is more appropriate in the short term for the sort of risks that providers are being required to bear under an outcome based payment model. Clearly the ownership structure of many social enterprises and mutuals does not permit conventional equity finance but ‘equity type’ instruments are required to facilitate their development.

Secondly it could give time to see whether cooperatives of social enterprise providers would develop. These may be able to take
on a Tier 1 contractor role rather than being entirely reliant on the large corporates to play this role. This would then facilitate a more mixed economy of provision. This would be not unlike the role which the Cooperative Wholesale Society used to play cooperatives in providing the benefits of size without adding an additional layer of profit margin.
Appendix 1: Summary of Green Paper proposals on Payment by Results

The Green Paper argues that a Payment by Results (PbR) scheme will put the concept of justice reinvestment into practice, allowing investors to channel money into innovative activities which prevent reoffending, rather than those which incur expense through dealing with the consequences.

Over the next two years a PbR approach will be developed and tested. The government intends to achieve this by: designing the Payments by Results model for reducing reoffending; commissioning at least 6 PbR projects encompassing a significant proportion of the offender population; publishing a comprehensive competition strategy in June 2011; determining how providers should be paid for outcomes.

It is recognised that the design of the PbR model must be carefully considered; this will involve tailoring PbR to different groups of offenders, and in some cases combining commissioning for rehabilitation with sentence delivery. The model must also allow for competition among a diverse range of service providers.

To be effective, PbR needs to reflect sentence type. Consequently, two broad models will be explored; one directed towards offenders receiving a community sentence, the other covering those sentenced to custody.

COMMUNITY SENTENCES

The Green Paper sets out the twelve options that a community sentence can include. ‘Managing offenders’ involves ensuring
that all requirements of a community sentence are delivered, enforced and that reoffending is reduced. The paper states that it is neither desirable nor practical for these objectives to be contracted for separately, and that it is preferable for one provider to oversee the overall community sentence. This would require two kinds of payments: first, payments for meeting statutory requirements and complying with the sentence; and, secondly, payments that are linked the results achieved in reducing reoffending.

**CUSTODY**

Offenders sentenced for more than 12 months are released on licence to probation, meaning that they will continue to serve whilst rejoining the community, subject to conditions. The overall sentence is managed jointly by case managers (while the offender is in custody) and the probation officers (while the offender is in the community). It would therefore be difficult to determine which organisation deserves most credit for reducing reoffending. The paper suggests that PbR may be most effectively focused on paying the provider of the probationary services as they represent the most continuous point of contact with the offender.

When convicted for less than 12 months, there is no supervision requirement upon release unless the offender is between the ages on 18 and 21. The paper suggests there is scope to develop PbR to pay some prisons by results for rehabilitating offenders; within the category of those convicted for less than 12 months, around 56 per cent in 2007 spent the sentence in a single prison. This would present an incentive for prisons to utilise time with offenders effectively and aid their reintegration into community life.

**ENCOURAGING GREATER DIVERSITY OF PROVIDERS**

The Ministry of Justice Business Plan 2011-2015 states that no rehabilitation services will be applied if a more effective option exists within the private, voluntary or community sectors. PbR must serve to ‘harness the creativity and expertise that independent providers can bring.’ Barriers that prevent
smaller providers becoming a part of this diversification will be reviewed – and competition will be increased with a view to achieving greater efficiency. Greater independence for public sector workers through the creation of social enterprises, cooperatives and mutualisation will also be considered, supporting the transition of the public probation service towards a PbR model. A comprehensive competition programme and market development programme will be published in June 2011.

PILOTING PBR

There are to be at least four PbR pilot projects: two large scale projects for offenders managed on community sentences and those released on licence, covering all appropriate offenders within a criminal justice area; and two projects for offenders released from prison, focusing on those convicted for less than 12 months. The design of these projects is to be refined by August 2011. The green paper also identifies scope for working with the Department of Health, Home Office and Department for Work and Pensions to achieve outcomes such as reducing drug use and sustaining employment.

PILOTTING A LOCAL APPROACH TO PBR

The paper suggests that local authorities, the police, probationary services and prisons can collaborate more effectively to reduce offending, thus reducing demand for criminal justice services. Decisions can be made locally to target resources on specific groups of offenders depending on the crime patterns of the particular area. Savings made through joint efforts could be shared and reinvested in local crime prevention schemes. The government plans to pilot this local approach in Greater Manchester and across several London Boroughs.

PAYMENT MECHANISM FOR REHABILITATION

In order to implement this, three factors must be determined: to which offenders it is appropriate to apply PbR; how to measure reoffending; and how to measure success.

PbR is not appropriate for all offending groups. Those that pose a high risk to the public would be excluded given that the focus
is on managing the risk of harm presented by such offenders. At
the other end of the spectrum, those unlikely to reoffend – for
example those subject to Community Payback – require fewer
resources and thereby enable the PbR system to target more
problematic groups.

Reoffending is currently measured by comparing rates of
reconviction and looking at whether the offender has been
reconvicted within one year of release or the beginning of a
community sentence. The overall level of reoffending can be
measured either by seeing whether the offender has reoffended
or the total number of offences an offender commits. The
Ministry of Justice Chief Statistician has launched a consultation
to determine the most effective test. In measuring success of
rehabilitation, the truest test could be whether an offender had
been convicted, cautioned or given a Penalty Notice for Disorder
for a further offence. Progress in reducing levels of reoffending
could be measured against a ‘predicted rate’ or against levels
from previous years. It is also understood that providers may
need to be rewarded differently dependent upon the types
of offender they rehabilitate as they may require different
treatment, for example female and minority ethnic groups.

PERVERSE INCENTIVES

To increase the chances of prevention it is paramount that the
provider is focused on delivering outcomes scrupulously, not
simply on meeting targets in order to receive payment. This
motivation may be minimised through preventing providers
choosing which offending group their success is measured
against, as has been applied in the Peterborough Social Impact
Bond pilot. Providers will also have to share information with
the police and other agencies if offenders present a risk to the
public.