

Government Commercial and Contracting: an overview of the NAO's work

Spring 2016



National Audit Office



Further details

For further information on this overview or the National Audit Office's (NAO's) wider commercial programme please contact:

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The National Audit Office scrutinises public spending for Parliament and is independent of government. The Comptroller and Auditor General (C&AG), Sir Amyas Morse KCB, is an Officer of the House of Commons and leads the NAO, which employs some 810 people. The C&AG certifies the accounts of all government departments and many other public sector bodies. He has statutory authority to examine and report to Parliament on whether departments and the bodies they fund have used their resources efficiently, effectively, and with economy. Our studies evaluate the value for money of public spending, nationally and locally. Our recommendations and reports on good practice help government improve public services, and our work led to audited savings of £1.15 billion in 2014.



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Why is it important?



Contracting for public services

Government now spends about £240 billion a year with private and voluntary providers. The role of providers in the public sector has evolved from relatively simple contracts to provide goods or established services, to innovative high profile commissioning arrangements in sensitive public service areas such as health and justice.

The NAO and the Public Accounts Committee have both acknowledged improvements in the government's management of contracts in recent years. But there is much more to be done for government contracting to be effective, meet expected public service standards and provide better value for money for the taxpayer.

Areas for further improvement include: greater transparency of suppliers' performance, costs and revenues; more effective competition for government business, both reducing over reliance on a small number of single suppliers and encouraging more small- and medium-sized enterprises into the market; stronger commercial skills within government when purchasing services, managing contracts and dealing with provider failure. Providers also need to demonstrate the standards of integrity expected from those delivering public services.

We see six themes in our work on government commercial and contracting:



Government's commercial capability



Managing contracted-out service delivery



Accountability and transparency



Government as one customer



Managing markets for public services

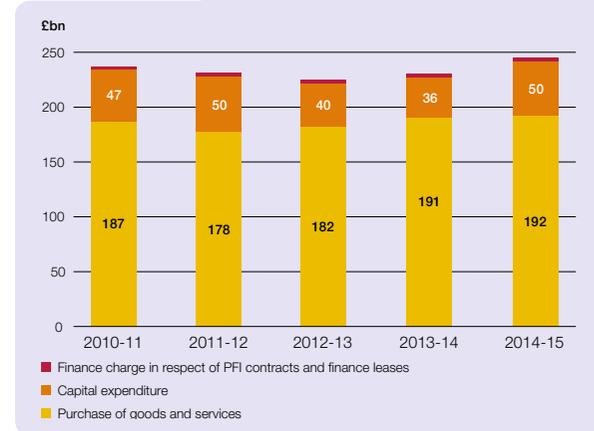
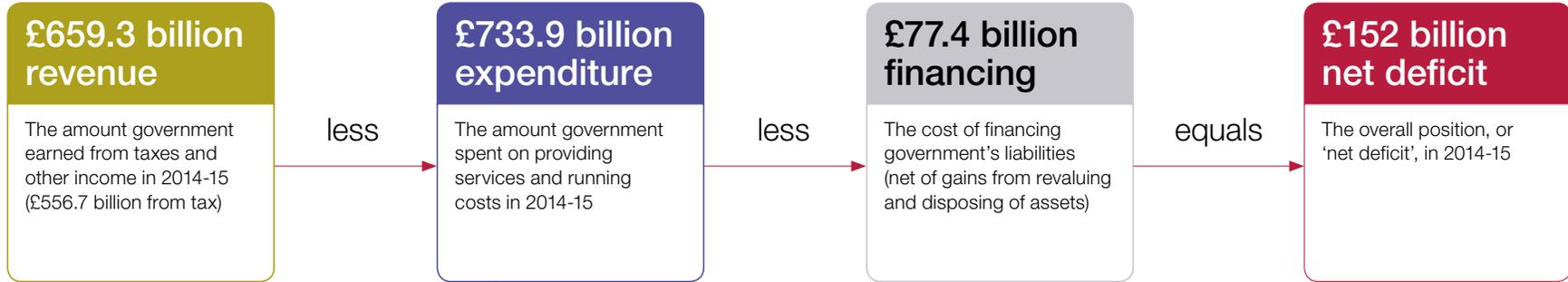


Using new commercial models

Contracting for public services

Financial overview: Whole of Government Accounts

Financial overview: other expenditure data



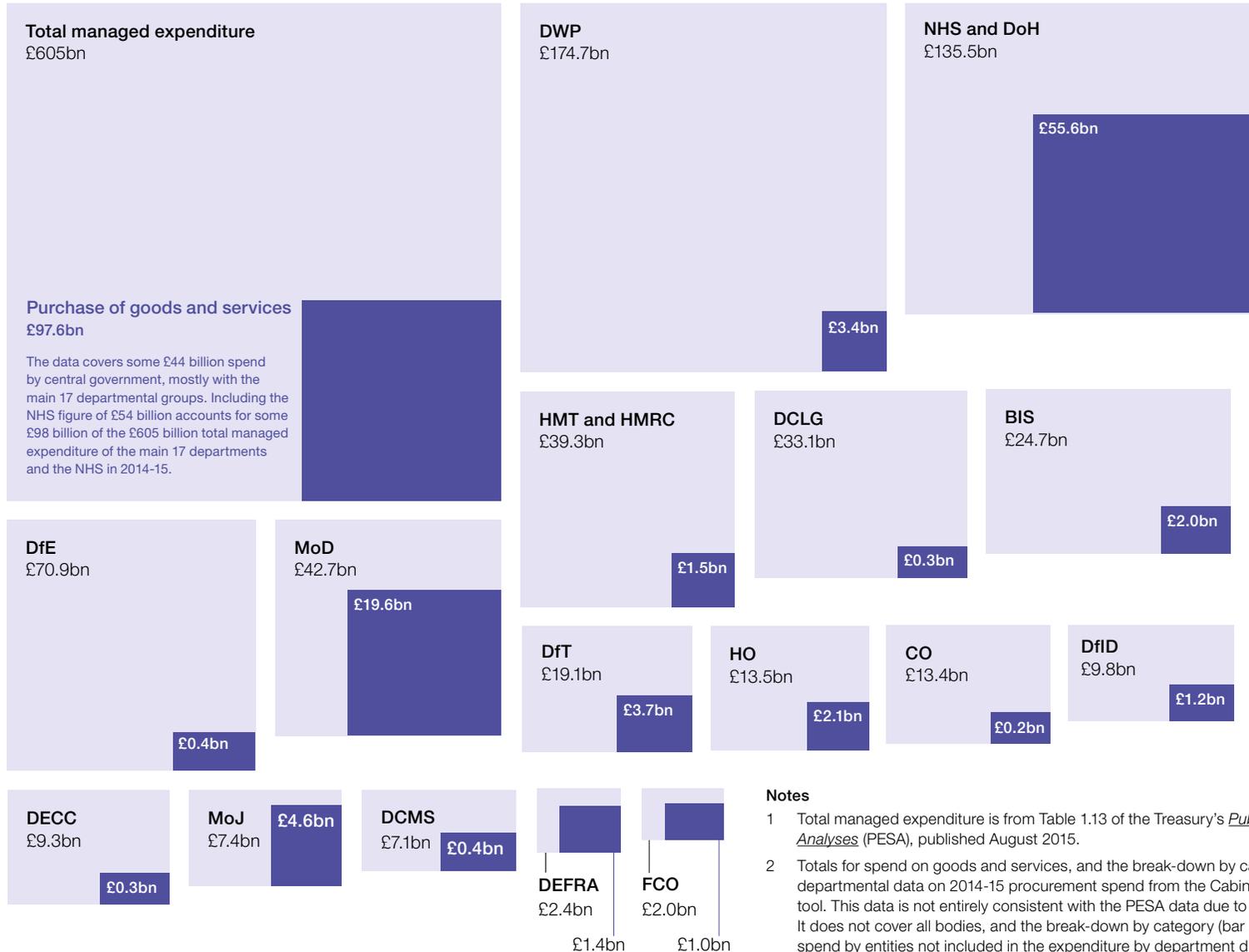
Source: Figures from Whole of Government Accounts for year ended 31 March 2015, published May 2016

Contracting for public services

Financial overview: Whole of Government Accounts

Financial overview: other expenditure data

Contracts are spread across government



Notes

- 1 Total managed expenditure is from Table 1.13 of the Treasury's *Public Expenditure Statistical Analyses* (PESA), published August 2015.
- 2 Totals for spend on goods and services, and the break-down by category, is from departmental data on 2014-15 procurement spend from the Cabinet Office's spend analysis tool. This data is not entirely consistent with the PESA data due to the way data is reported. It does not cover all bodies, and the break-down by category (bar chart) includes some spend by entities not included in the expenditure by department diagram.

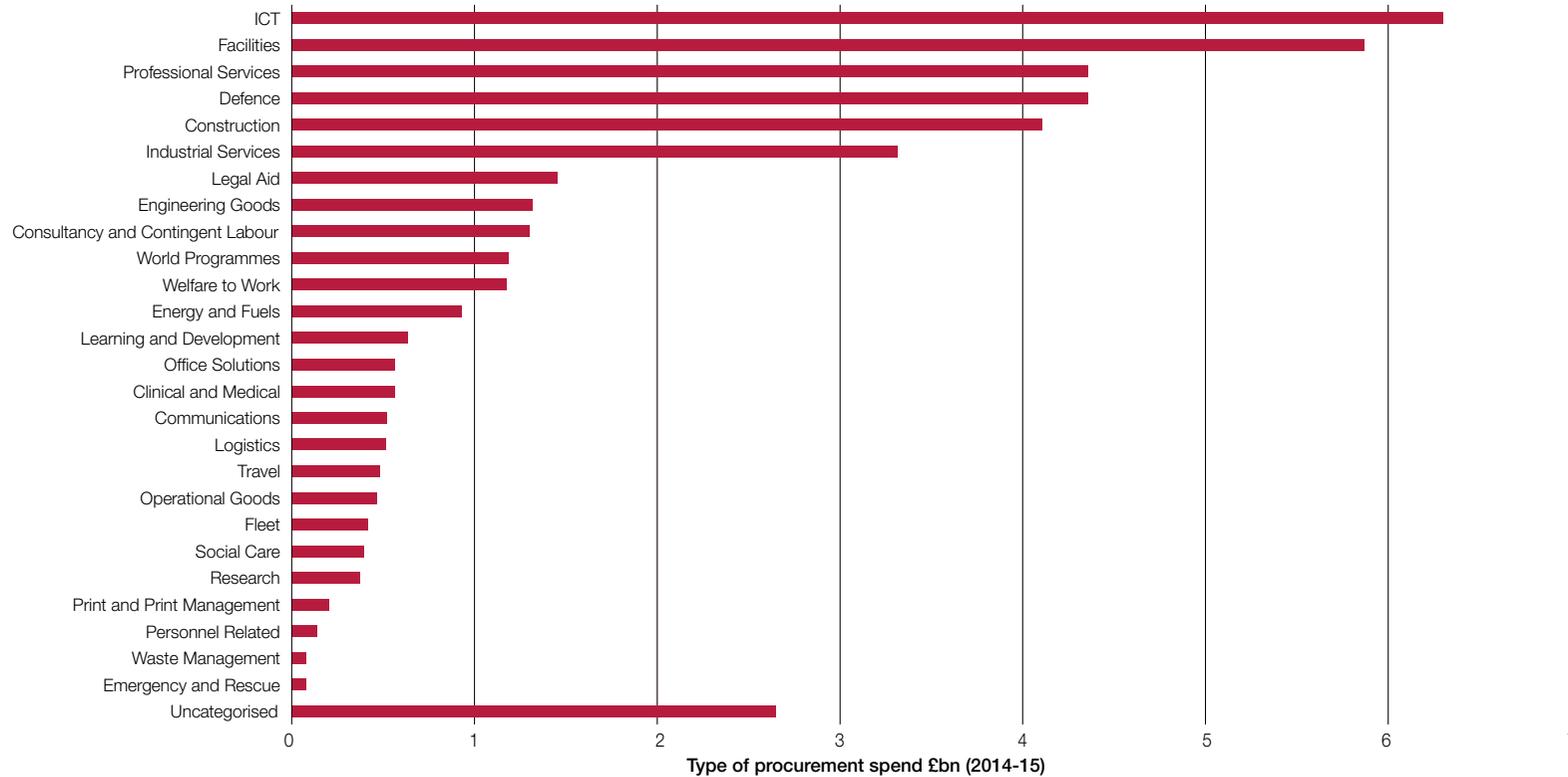
Notes continued overleaf

Contracting for public services

Financial overview: Whole of Government Accounts

Financial overview: other expenditure data

Government is using contracts to deliver complex public services as well as traditional back-office services



Notes continued

- 3 The figures shown are for 2014-15 outturn except for 'HMT & HMRC' where the 2015-16 budget figure is used because the HMT PESA outturn figure is negative, due to the financial sector interventions.
- 4 As the Cabinet Office's spend analysis tool does not cover the NHS, the figure shown for purchase of goods and services by "NHS & DH" has been estimated by adding the 2014-15 WGA figure for the NHS to the Department of Health figures from the spend analysis tool.
- 5 The DCLG PESA figure includes the administration of DCLG and funding for delivering departmental responsibilities such as housing, planning and regeneration policy.
- 6 The expenditure data from the Cabinet Office's spend analysis tool is provisional and has not been validated with departments. We published similar analysis for 2012-13 in our 2013 report *managing government suppliers*.



Government's commercial capability

Poor management of contracts is a long-standing issue. In our 2008 cross-government report *Central government's management of service contracts* we said that no commercial director or head of procurement rated the resources allocated to managing major contracts as 'good'. We highlighted poor risk management, inadequate performance measurement and limited use of performance incentives. The 2013 *Cross-government Review of Major Contracts*, instigated after the Ministry of Justice's discovery of overbilling on its electronic monitoring contracts, revealed continued weaknesses in the way major contracts were managed.

Government is now taking the issue seriously, and reforms since 2013 are going in the right direction. Government's December 2015 update to Parliament on progress with improving commercial capability set out how:

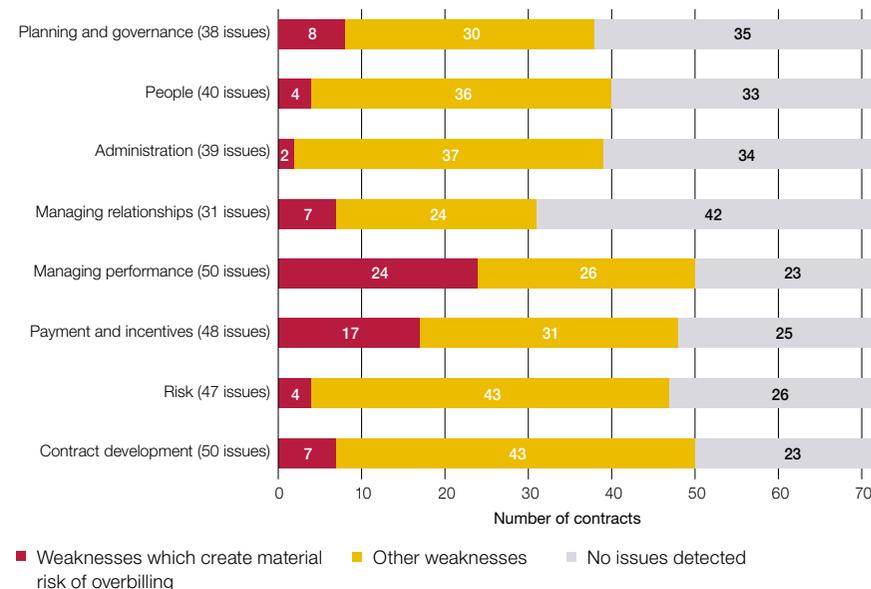
- Departments are building on their 2014 contract management improvement plans and 2015 commercial capability reviews to produce 'Blueprints' setting out their target commercial capability. These are expected to reflect a government-wide shift of emphasis away from a procurement focus and more towards managing commercial relationships and delivering value for money throughout the life of the contract.
- The Government Commercial Function in the Cabinet Office will focus on developing the commercial profession through central recruitment of senior specialists, skills assessment and development of existing staff, and a new commercial civil service fast-stream programme.

However, the problems are systemic, deep rooted and cultural, so will take sustained effort to address. There is a particular need for:

- Reform to departmental governance to ensure contracts are properly overseen;
- IT and information systems to support end-to-end contracting, including contract records management, performance and management systems, and data on spending;
- An enhanced and more credible commercial profession, with a clearer role in managing providers, attractive career progression and professional development; and
- The better integration of commercial specialists with the operational staff responsible for front line oversight of service provision.

The 2013 reviews found issues against all areas of our framework

Contract management framework area



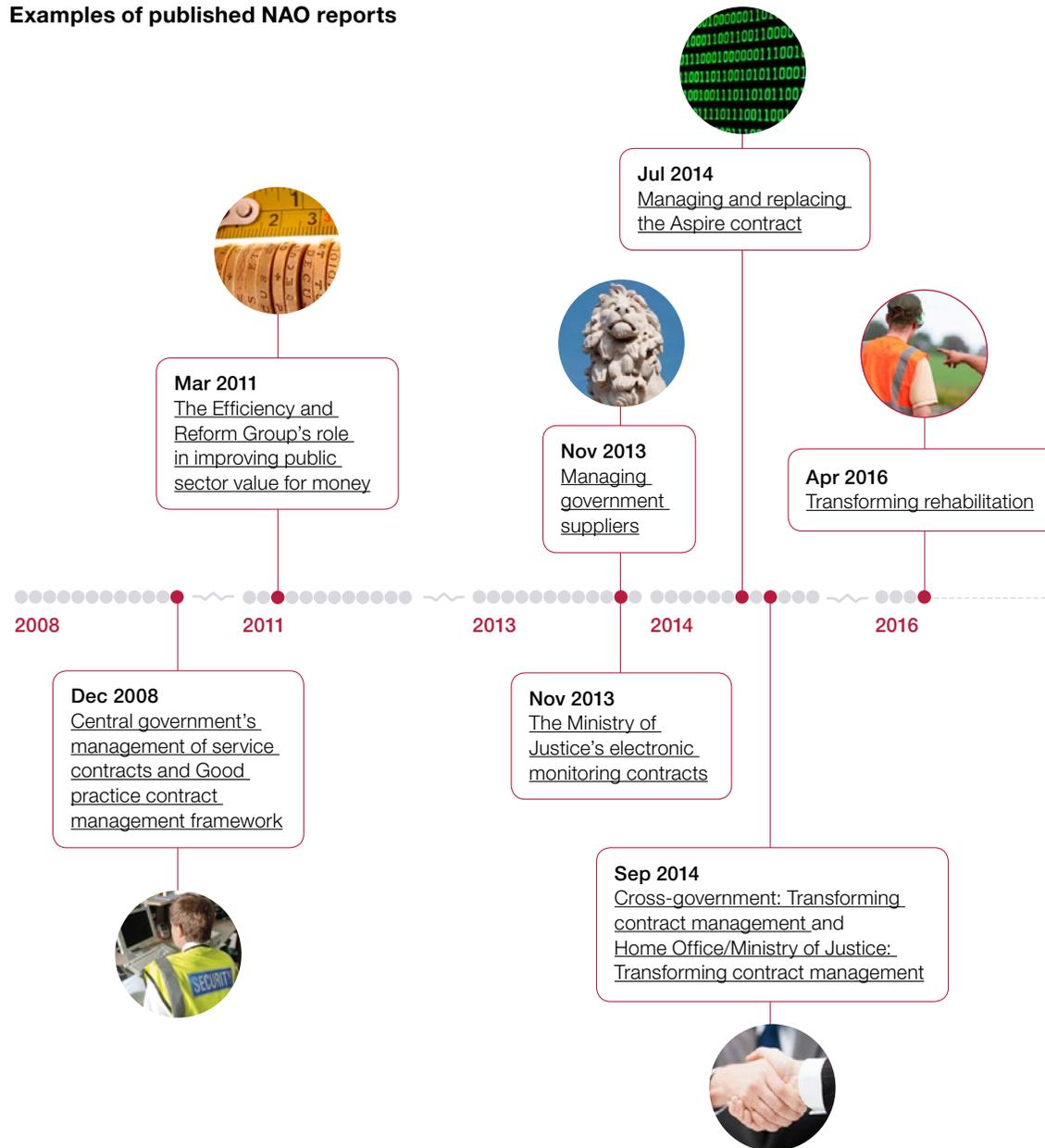
Notes

- 1 Includes the cross-government review (28 contracts with G4S and Serco, all of which were tested for overbilling), the Ministry of Justice (17 reviewed, of which 7 were also tested for overbilling), the Home Office (13 additional to the cross-government review, of which 5 were tested for overbilling) and the Department for Work & Pensions (15 contracts, which were only tested against the framework). This does not include a further 20 Ministry of Justice contracts tested only for overbilling.
- 2 In total 73 contracts (with various contractors) were reviewed against the NAO framework and 60 were tested for overbilling.

Source: National Audit Office, *Transforming Government's contract management*, Figure 3, September 2014



Examples of published NAO reports



Examples from our recent work

Transforming Government's Contract Management (2014)
Cross-government reviews following the discovery of over-billing on electronic monitoring contracts found widespread problems with contract management. The root causes of poor contract management included government's disadvantage in commercial capability, with the commercial profession having low status within the civil service. This needs to be addressed by widespread change in the culture of the civil service and a targeted focus on commercial capability.

Transforming Contract Management in HO and MOJ (2014)
This report sets out a comparative analysis of the steps taken by the Home Office and Ministry of Justice to reform their contract management governance and capability.

Transforming Rehabilitation (2016) – This report describes how the Ministry of Justice has applied lessons from previous failures and has invested heavily in robust contract management of the 21 Community Rehabilitation Companies running outsourced probation services. Direct contract management resources account for some 2.1% of contract spend, and are deployed through the Ministry's new multi-disciplinary model whose potential we reported on in 2014.

Latest PAC report
Public Accounts Committee: Transforming contract management progress review (2016) – Government's 2015 programme of commercial capability reviews found consistent themes including capability too focused on procurement rather than market-shaping or contract management, high vacancy levels in commercial roles, and the need to improve the commercial skills of operational staff and strengthen lines of accountability. There are encouraging signs of change, but the current pace of progress with reform is disappointing.

Managing contracted-out service delivery

More and more complex public services are being delivered by private providers through contracts. The traditional model of contracting demanded a clear specification, an orderly competition, a transparent and easy to use service level agreement tied to a payment mechanism that incentivises performance, and an assurance regime by the contract manager to ensure contractual compliance. The reality of complex service provision means this model needs reform. In practice:

- There may be few credible providers of a service.
- Services can be complex. Such services cannot be fully captured in a specification or service level agreement. While a procurement process may result in a “good contract” promising savings and improvements, the contract alone cannot be relied upon to deliver them.
- The government is not always the end user of the service and may not be present at the point of delivery. This can make it difficult to assess quality of provision.

We see too many examples of poor performance and misbehaviour by providers. We also see the opposite of a level playing field where government is often out-negotiated. However, we also see government starting to be more willing to push providers and to use its political influence with them.

Our work looks at how well departments manage contracted-out services, emphasising not only effective project management, contract management and governance, but also the wider ways in which departments can provide effective management and oversight of contracted-out services. Our work also emphasises the role of providers in public service delivery. Through our work we have recommended:

- Providers being accountable and taking responsibility for the delivery of the services they contract for.
- The government using a better understanding of its providers to influence its management of them.
- The use of open-book accounting to help government better understand its providers and the services.
- Clear penalties for misbehaviour and misreporting.
- The use of the credible threat to reputation, recognition of strong performance and the emphasis on the long-term relationship with strategic providers.

“The Review has confirmed that the way many of the government's important contracts are managed is inadequate and the capability of both suppliers and departments needs to improve. The failings could, if left unchecked, lead to future erroneous charging for services delivered or opportunities missed to intervene at the right point in order to make necessary corrections. Allowing this situation to continue is not an option.”

[Cross-government review of major contracts, HM Government, Autumn 2013](#)



Examples from our recent work

Home Office: E-borders and successor programmes (2015) – In 2007 the Home Office entered a contract with Raytheon to deliver its e-borders programme. The department terminated the agreement in 2010 citing a failure to deliver milestones. The commercial strategy of fixing the price and milestones while leaving requirements too open created disputes after contract award over whether Raytheon's solutions would meet actual needs. Nor could Raytheon compel essential cooperation by other government agencies or by transport carriers. Relationships became more difficult, with indicators of friction including the absence of a working partnership agreement expected to encourage cooperative working, and a failure to co-locate staff. By 2010 commercial differences had accumulated to a point where they could not be closed.

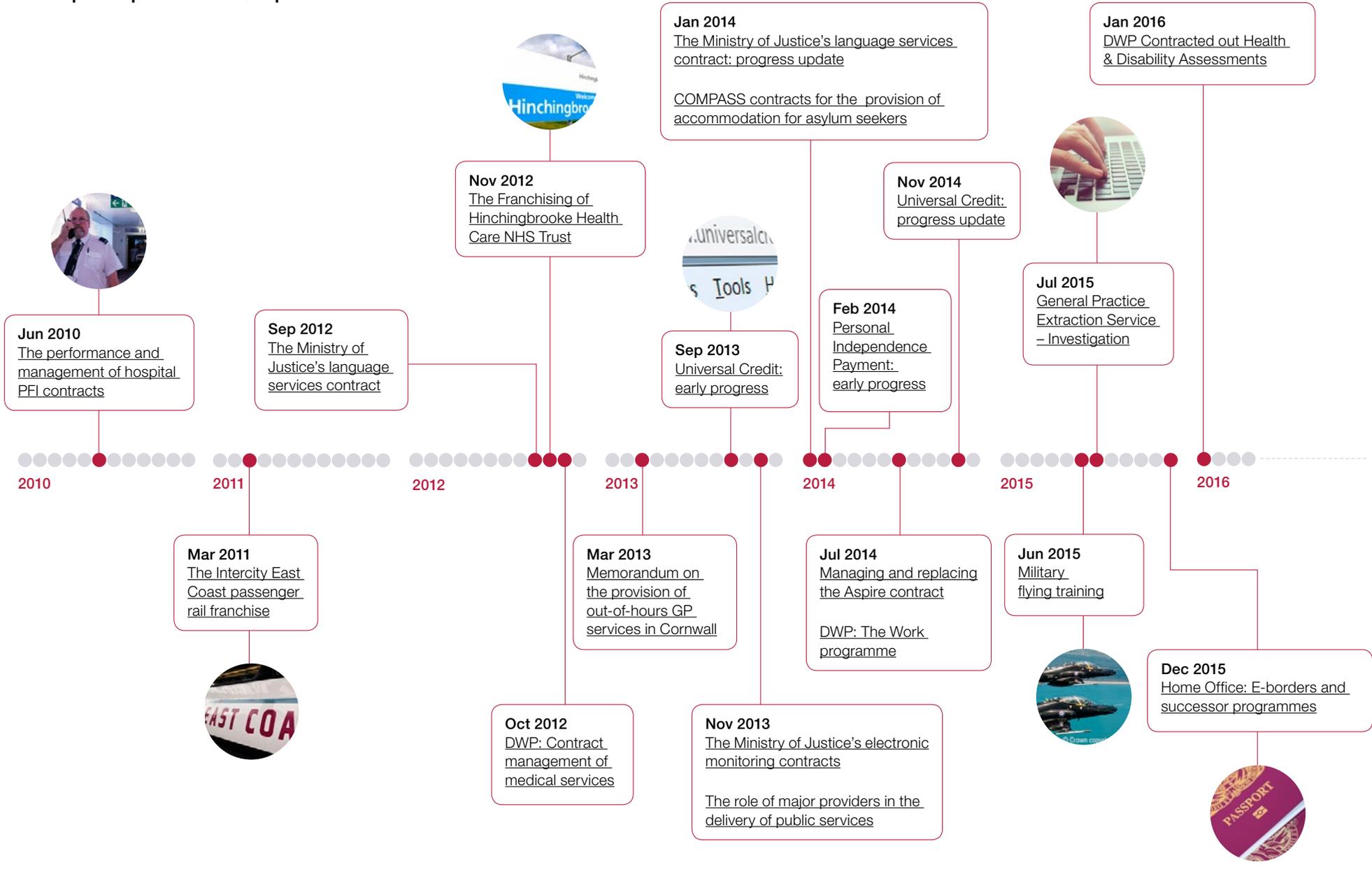
DWP Contracted-out Health & Disability Assessments (2016) – This report highlights how the DWP has increased its capacity for contract management but has continued to set high targets and use assumptions without evidence of sufficient testing and challenge. DWP's approach to managing contracts and critical assumptions risks perpetuating a cycle of optimistic targets, contractual underperformance and costly recovery.

MOD Military Flying Training (2015) – This report covers the MOD's 25 year contract for military flying training. It highlights concerns the department had about the provider's performance, and difficulties it had applying effective incentives and performance deductions to hold the provider to account.

DWP Universal Credit: progress update (2014) – This report highlights an improved control framework DWP launched in response to various reports on the Universal Credit programme. The framework includes clarification of contract management roles, improved information on provider performance and more measurable milestones in contracts.



Examples of published NAO reports



Accountability and transparency

Government departments and their accounting officers remain accountable for the services they contract out. This includes ensuring that arrangements for contracting-out contain appropriate accountability for using public funds. But the quality of the service is dependent on the provider, and the provider's systems, people, controls and culture. Holding the client contract manager to account for the service is not sufficient. To an extent, the provider must also be accountable for the services they undertake to deliver.

The system of accountability is starting to change to reflect the way accounting officers delegate responsibility for delivery to the provider. This delegation leaves both accountable. In November 2013, for the first time four major providers – Atos, Capita, G4S and Serco – appeared before the Public Accounts Committee to answer questions about their public sector business as a whole. This was part of a wider trend of providers appearing before the committee to account for their performance on specific projects and contracts.

Much of our work looks as much at the provider's performance in the delivery of a service as it does that of the department which contracted them. We aim to 'follow the pound' to ensure Parliament is able to hold whoever is responsible for delivery of the service to account.

Providers' accountability is greatly enhanced through increased transparency. Contracting creates the opportunity for enhanced transparency over public services because it creates management information over performance and the costs of a service. This can be made available to contract managers through the use of open book clauses, as highlighted in our July 2015 report *Open book accounting and supply-chain assurance*.

Information can also be made more widely available through public transparency measures. While performance for some contracts, such as DWP's Work Programme, is already published on a systematic basis, the Public Accounts Committee have often commented that too much information is censored on the basis of commercial confidentiality.

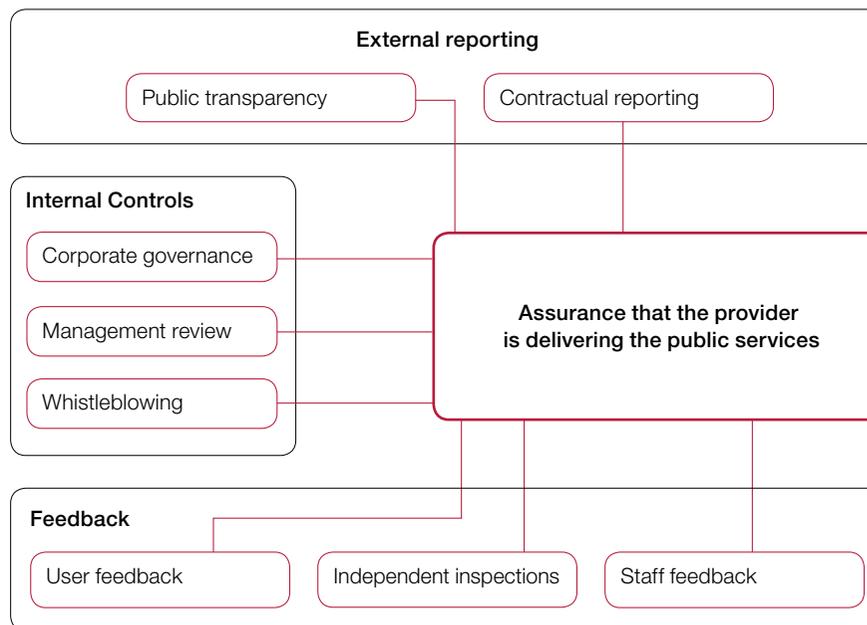
In 2015 government produced its policy paper *Transparency of Government and Suppliers to the Public*. This set out the need for common transparency standards and approaches across government contracts with a presumption in favour of disclosure over the 'vast majority' of commercial information. For contracts worth over £20 million per annum, government is seeking to make available transparency data over revenue levels and profit margins.

Although Government's aim is to be transparent, it is not clear it has the ability to be. Its ambition and ability to publish transparency information remains hampered by weak information systems that mean that contract information, spend data and performance information cannot easily be brought together.



"There needs to be far greater visibility to government, parliament and the public about suppliers' performance, costs, revenues and profits."

Public Accounts Committee, 2014

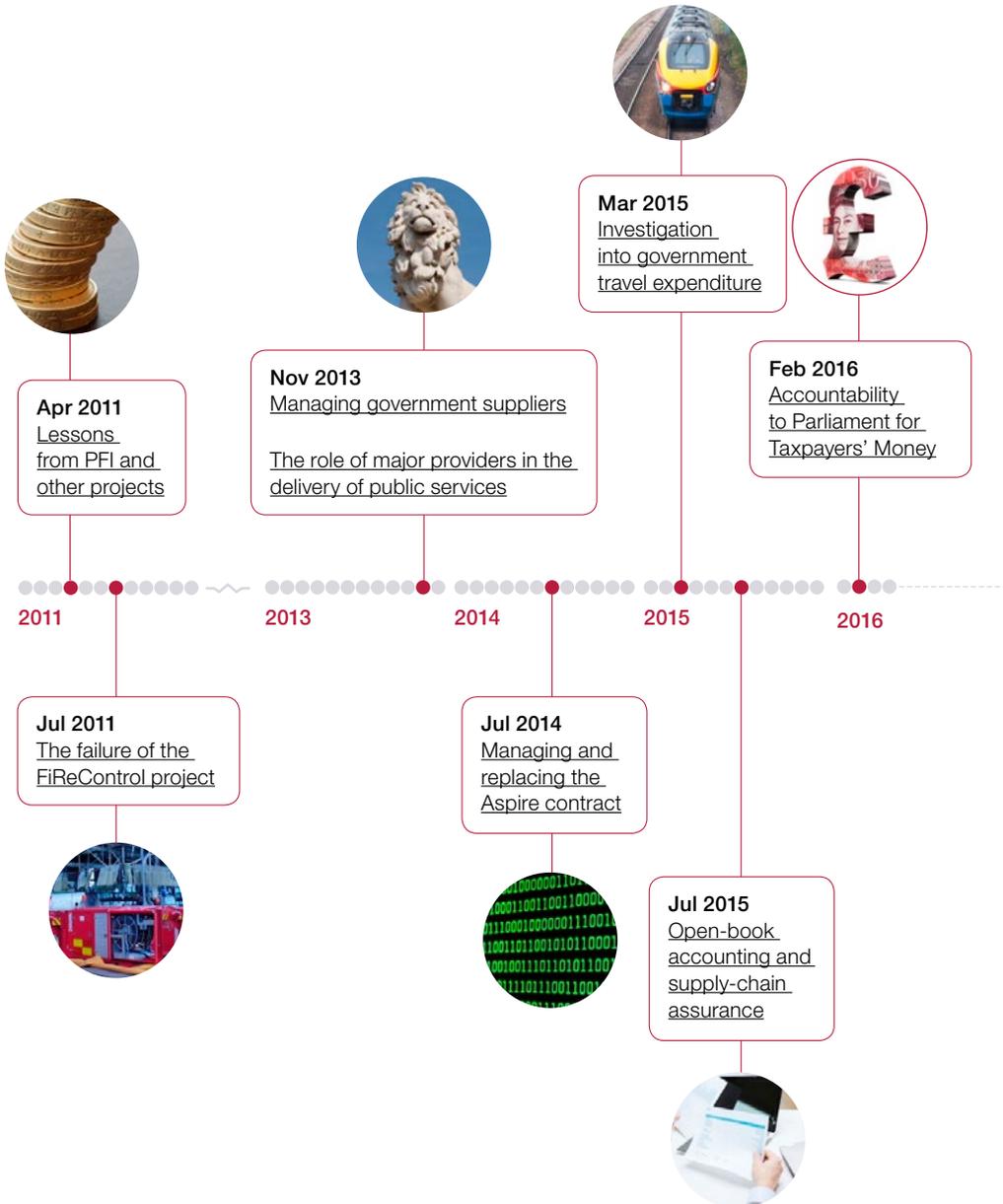


Source: Figure 22, *The role of major contractors in the delivery of public services*, National Audit Office, November 2013

"...all businesses delivering public services need to do more to build a trusting relationship with the public."

Confederation of British Industry, 2014

Examples of published NAO reports



Examples from our recent work

Open Book Accounting and Supply Chain Assurance (July 2015) – The private sector case studies set out in the report showed client scrutiny of the supply chain was expected by suppliers, and that good contract managers saw it as their job to be inquisitive about what their suppliers are delivering. However less than a third of government contracts have open book clauses and few government bodies have a policy on when to include open book accounting in a contract. The most frequently-cited limitation of open book accounting was the skills and resources to use it well.

Accountability to Parliament for Taxpayers' Money (February 2016)
This report shows how outsourcing is one of the developments complicating accountability across government. It highlights PAC's expectation that senior managers in providers will be personally accountable for performance alongside accounting officers.

Latest PAC report

Public Accounts Committee: Transforming contract management progress review (March 2016) – Government must strengthen the way it holds providers to account and protects vulnerable service users. Government should be clear providers will be held to account by Parliament and have this codified in contracts.



Government as one customer

Government has recognised that it needs to act as one customer to exploit its buying power in the market, and to reduce duplication and inefficiencies in the process. This has led to the creation of the Crown Commercial Service (CCS). CCS is a new organisation with ambitious plans to change how government buys some £15 billion of common goods and services.

A focus on achieving savings in government's commercial relationships has driven further activity at the centre, including the renegotiation of contracts with strategic suppliers, the introduction of Crown Commercial Representatives to lead negotiations, and the use of strategic supplier information to inform contracting decisions.

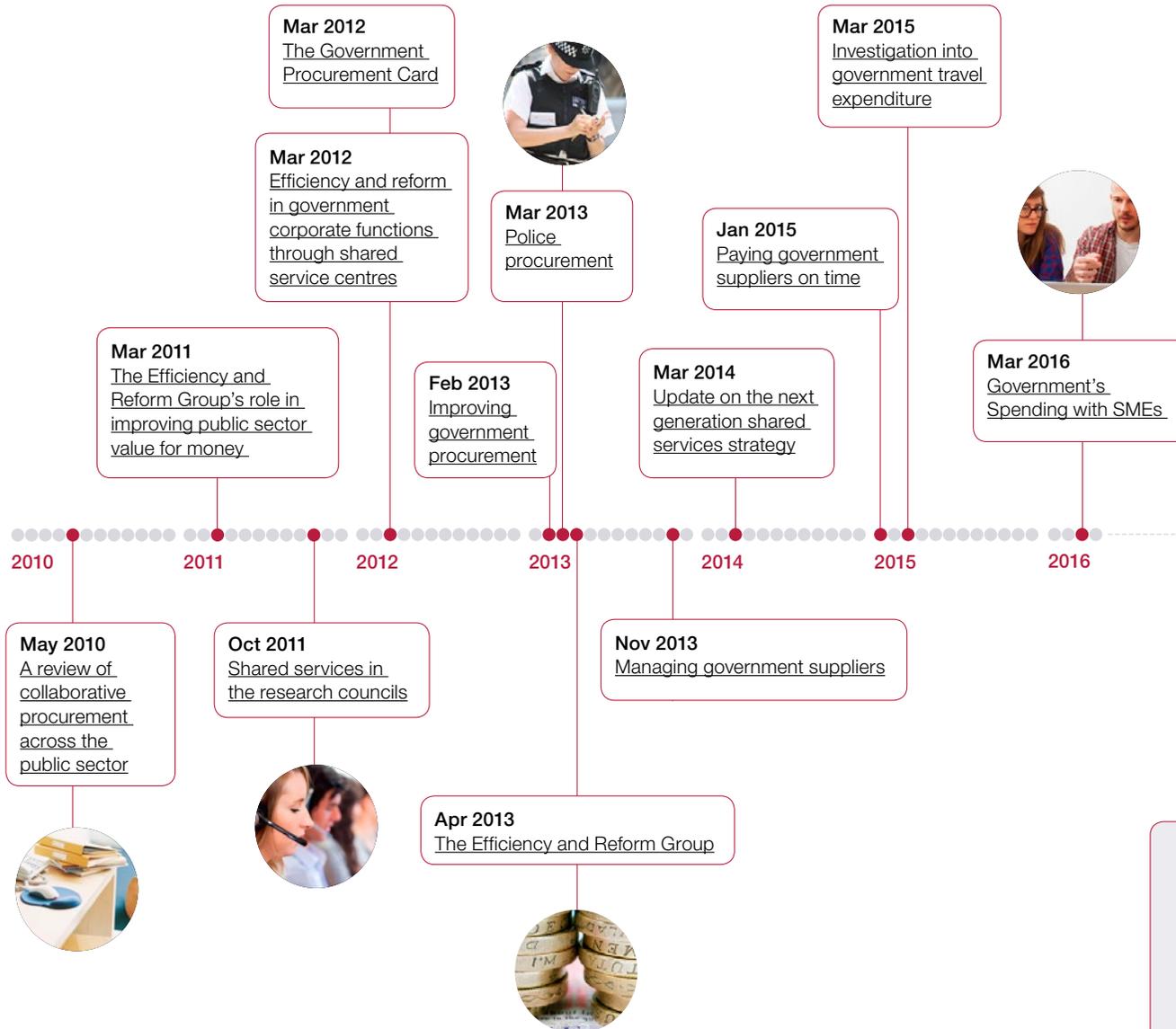
The NAO has been supportive of this agenda, believing that it provides the opportunity to drive down costs and improve services. However, our previous reports *Managing Government Suppliers* (2013) and *Update on the next generation shared services strategy* (2014) highlighted a range of challenges, including:

- Unclear accountability between the centre and departments. Central oversight and control, such as interventions through the spending controls process and management of supplier relationships, challenges existing accountability structures. It may be necessary to do this in order to change the system, but longer-term goals may be at risk if departments are not on board.
- Clarifying the operating model for the centre and departments to allow departments to determine how their own commercial functions should operate.
- The rapid expansion and ambition of the Crown Commercial Service brings risks in terms of being able to meet departmental demand for services, and to recruit to keep up with the required capability.
- The centre maintaining clear leadership of a cross-government programme, and working closely with departments to achieve the anticipated savings.
- Helping departments to become 'intelligent customers' of the shared services. This includes changing departments' ways of working to get the most out of the centres and to realise the value of the initiative.

"Departments and their associated organisations are the 'contracting authorities', responsible for managing contracts. Accountability for the performance of contracts rests with departmental permanent secretaries. These traditional structures of accountability are challenged as the Cabinet Office takes on more commercial activity on behalf of government departments."

Managing Government Suppliers,
National Audit Office, November 2013

Examples of published NAO reports



Examples from our recent work

Government's Spending with SMEs (2016) – Individual contract awards are decided by departments, but by identifying and removing barriers faced by SMEs across government, the Crown Commercial Service aims to make it easier for them to do business with government. Government has abolished pre-qualification questionnaires for low value contracts and required departments to use Contracts Finder to advertise opportunities. SMEs report some positive developments but the most commonly-cited barriers have not changed.

Managing Government Suppliers (2013) – This report sets out the actions government has taken since 2010 to establish a firmer grip on supplier management. This includes the establishment of the strategic supplier programme and the crown representatives.

Future NAO publications

Crown Commercial Service (Autumn 2016) – The Crown Commercial Service is now responsible for £15 billion of spending across government. This study will look at the CCS' business model, how CCS and departments are working together, and how well CCS is managing its growth.



Managing markets for public services

We have previously expressed concern about government's over-reliance on a small number of providers in certain markets, with the effect that these providers are treated as if they were too important to fail. We see a growing recognition of government's market stewardship role in commissioning, not only across central government, but also in local government, health, police and social care.

Government has aimed to reform its procurement practices and make procurements easier to access. It has also tried to reform the ICT markets to move away from long-term contracting with a prime provider for delivery of a range of integrated services, to disaggregated and smaller contracts. These initiatives aim to open up the supplier base and allow SMEs to participate, thereby providing greater access to innovation and competition.

Government has also made attempts to stimulate new markets, such as in the recent Transforming Rehabilitation competition, and to bring in new providers to existing markets, such as in DWP's medical services contracts. Government also needs to guard against the consolidation of markets, using its powers to prevent changes of control where appropriate.

Our recent work has highlighted that government needs to understand the risks of provider failure and how it can be managed effectively. The failure of a provider can be the necessary price of innovation or come from effective competition, keenly priced contracts and robust contract management. However, the failure of a provider can have serious consequences and departments must manage failure effectively, in order to ensure continuity of services, and to protect the interests of people who use them.

It is also important that government understands its markets and providers, including their business model and their strengths and weaknesses, so that it can shape its contracts to attract the right providers to the market and then manage them appropriately. Providers that have grown too quickly, or that have made a poorly judged entry into a new part of the market, present particular risks as they may not have adapted their existing control culture to meet the demands of the new service.

Managing provider failure: Our principles

Strategy and Planning

Understand the appetite for failure: departments should consider the potential impact of a provider failure and decide their appetite for it. They may wish to consider a range of factors including the impact of failure on users and the reliance of their delivery mechanism on individual providers.

The appetite for failure may be high, for example where they are using market mechanisms where users choose providers and there are many alternative providers. It may be low, such as where the department co-produces with a provider and shares the financial or reputational risks.

Plan a delivery model which aligns to the appetite for failure: departments should select a delivery model that aligns with their appetite for failure.

Plan for how to respond in the event of a provider failure: departments should have a sufficiently detailed plan for how they would respond if a provider should fail.

Measurement and Implementation

Put in place appropriate oversight to monitor providers, proportionate to risk appetite: departments should establish and use appropriate arrangements to detect failure and early warnings of it.

Agree with providers and service users what constitutes failure and its consequences: departments should establish a shared understanding with providers (and service users) about what constitutes failure, to make it easier to identify. Departments should also consider how far transparency about what will happen in the event of a failure will encourage positive behaviour, and how far it will enable providers to 'game' the system.

Balance the need to be consistent with the need to respond to individual circumstances: when a provider fails, departments should weigh the risks of the 'moral hazard' arising from a rescue of a failing provider, against the risks that that failure involves. Departments should consider how far their risk appetite has changed since they planned for failure: for example as user vulnerability changes.

Evaluation and Feedback

Assess the ways in which the response to a failure has affected the perception of the appetite for failure and therefore the incentives operating upon providers. When a department acts it will reveal some of its appetite for failure. If the response has created moral hazard, then the department will need to take steps to ensure that it manages that risk in the future.

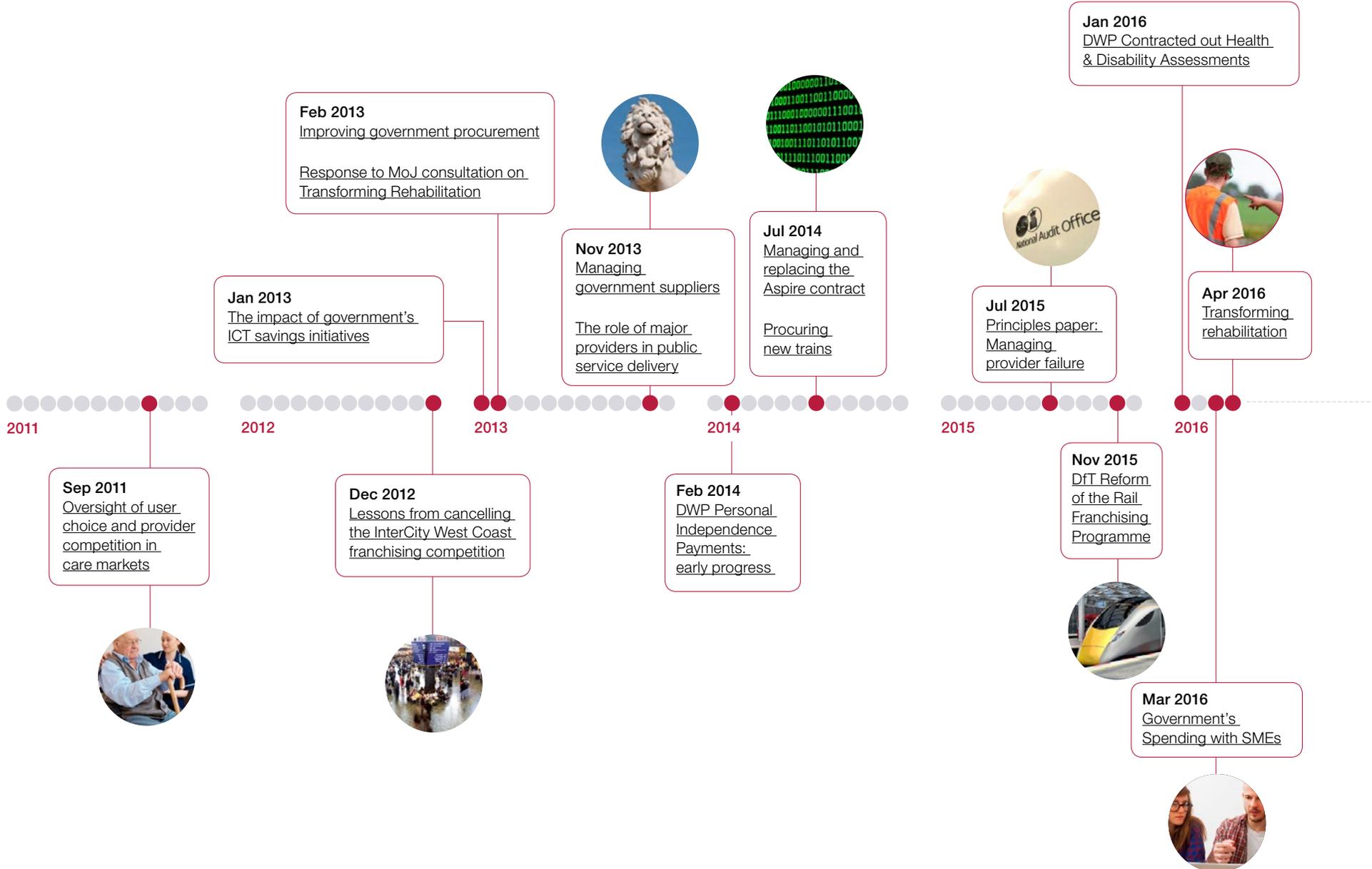
Reconsider the health of their providers: after a failure, departments should try to identify whether the failure of a provider is an individual instance or a pervasive issue.

Share lessons about failure within and outside the department: government as a whole needs to learn from each major instance of provider failure.

Source: *Principles paper: Managing provider failure*, National Audit Office, July 2015



Examples of published NAO reports



Examples from our recent work

DWP Personal Independence Payments: early progress (2014) and Contracted-out Health & Disability Assessments (2016) – When contracting for health and disability assessment providers for its new Personal Independence Payment benefit, the department learned from experience and established a framework of providers to broaden the market. It then appointed Capita alongside Atos, the existing provider of other health and disability contracts. Following Atos's withdrawal from its contract to provide health and disability assessments for Employment Support Allowance, a third provider, Maximus, was appointed. The department has since sought to better understand the process by establishing an in-house health and disability assessment service and increasing contact with providers. However the department risks damaging market interest through tight timetables, inflexibility and lack of transparency. Its framework contract for providers has only been used once and will expire in 2016.

DfT Reform of the Rail Franchising Programme (2015) – This report highlights the risk to value for money which could result where there is insufficient market to generate intense competition for franchises, and notes some of the actions DfT is taking to try to encourage new market entrants. These include simplification of pre-qualification processes and review of the number and size of franchises. We recommended that the department develop alternatives to its current commercial approach, such as including more competitive negotiation and dialogue to help drive a better deal, in the absence of intense competition.

Government's Spending with SMEs (2016) – Government believes SMEs can potentially offer more flexibility, innovative approaches and better value for money than larger providers, as well as local investment and improved social outcomes. This report comments on the progress government has made removing barriers to SME participation in public service markets, and the risks that remain. It also recommends that government target those sectors and markets where SMEs can have the most impact.

Principles Paper: Managing Provider Failure (2015) – Our experience of auditing government over many years suggests that the way failure of providers is considered and managed leaves room for improvement. This paper draws together common findings from our work, to assist departments in meeting this challenge.

Using new commercial models

With £225 billion of outsourced spending, providers have the potential to contribute enormously to the reform of public services and in helping to respond to austerity and overall reductions in public expenditure.

However, the traditional outsourcing model of contracting-out an existing service to a provider aiming to deliver the same thing on a more efficient basis will only take this so far. Generally such outsourcers accept very low levels of risk and are paid low margins as a result.

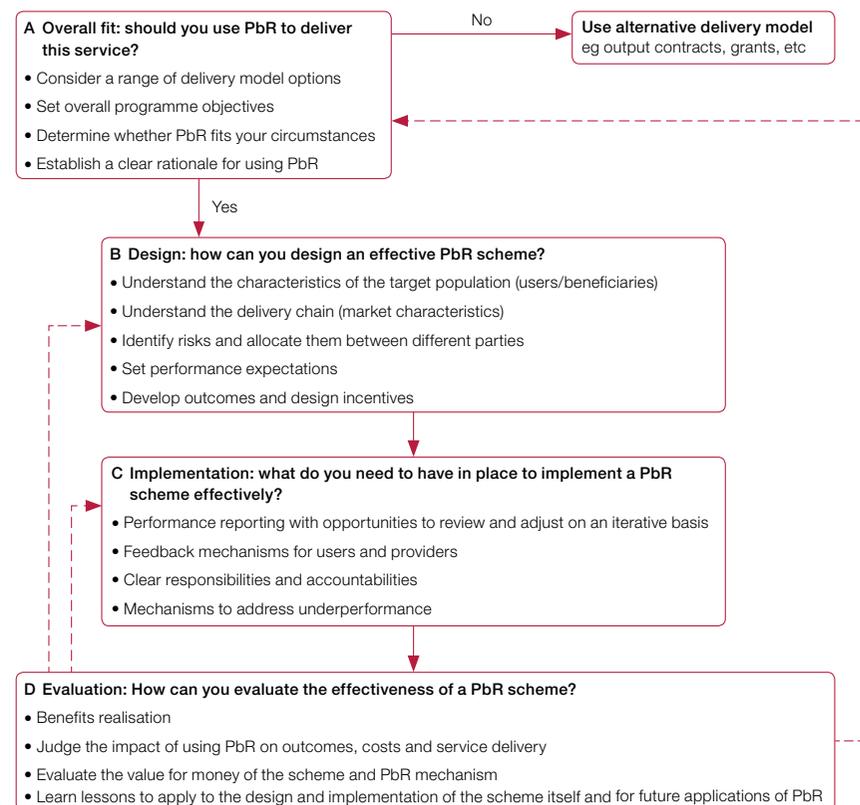
Government is aiming to try out different commercial models with different incentive structures and ways of working. These include:

- **Payment by results (PbR)** – which focuses payment on the successful delivery of outcomes rather than inputs;
- **Contracts for difference** – which pay providers in accordance with the difference made to the value of an asset or business;
- **Joint ventures** – where government and providers jointly own a service-providing business;
- **Mutuals and social enterprises** – not-for-profit organisations which may be 'spun out' from existing public sector organisations, or newly competing in markets for government services;
- **Management insertion** – which embeds private sector staff within the management of public sector organisations and pays them by results; and
- **Social impact bonds** – a means of attracting up-front private finance to support providers looking to transform services on a payment by results basis.

Our work has provided early reports on the success and failures of new commercial models and highlighted the need for purposeful experimentation – when trying something new, it is important to capture the learning and assess whether it works.

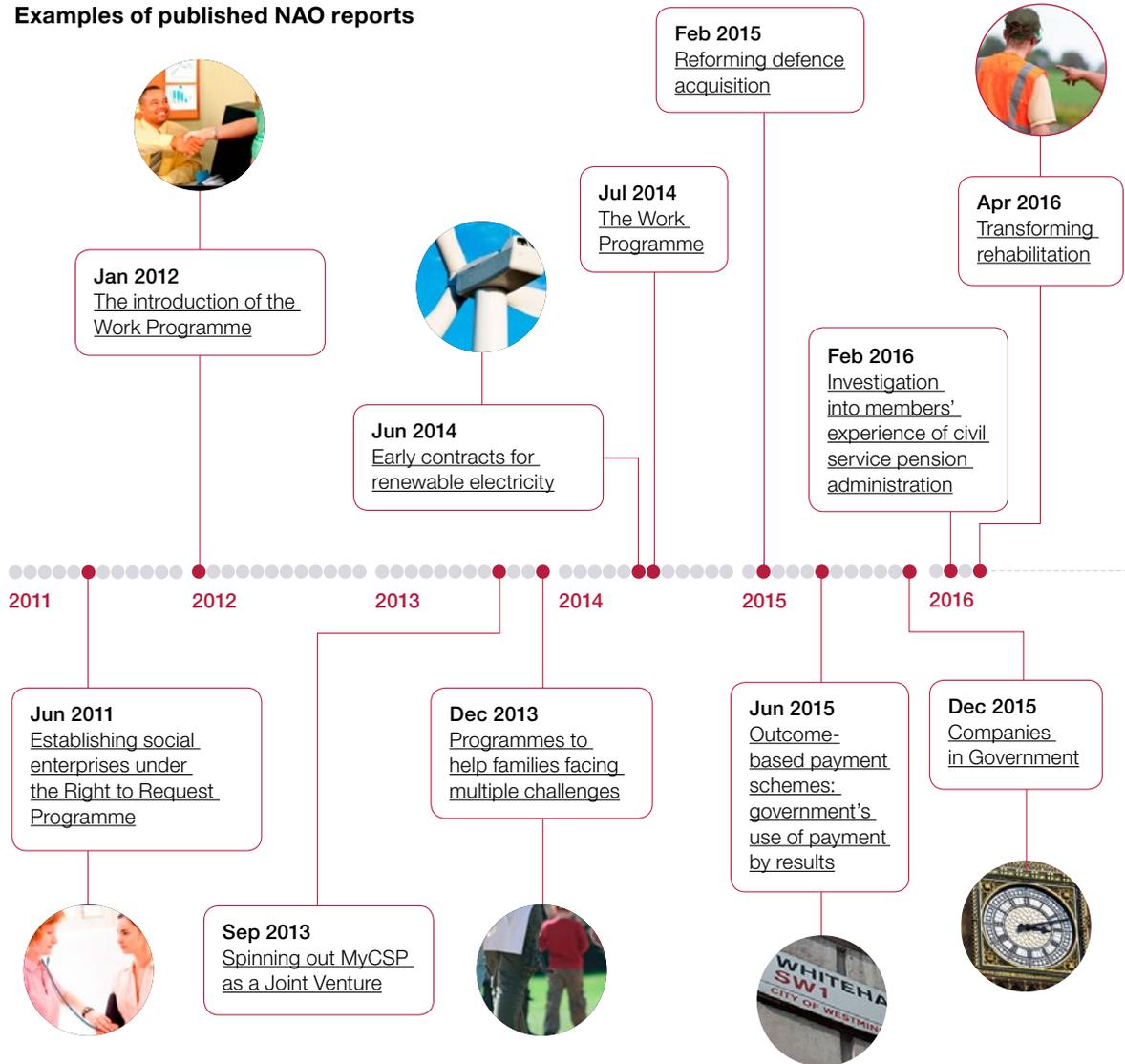
Payment by results: analytical framework

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



Source: National Audit Office, *Payment by results: analytical framework for decision-makers*, Figure 2, June 2015

Examples of published NAO reports



Examples from our recent work

Outcome-based payment schemes: government's use of payment by results (2015) – An estimated £15 billion worth of Payment by Results (PbR) schemes have been established since 2009. PbR contracts are most likely to succeed where results can be measured and attributed to providers' interventions. PbR is technically challenging with costs and risks that are often underestimated. Commissioners should justify their choice of PbR over other contract mechanisms so decisions are open to scrutiny. Commissioners need to be aware of the risks they retain in the event of providers failing to meet objectives. PbR mechanisms do not remove commissioners' responsibilities for overseeing provider performance.

Transforming Rehabilitation (2016) – This report shows how the Ministry took account of limited provider appetite for delivering probation services on a payment by results (PbR) basis. The resulting commercial model with only around 10% PbR increases the risk that innovative approaches to reducing reoffending may not be adopted by providers. The 'Fee for Service' model needs to better incentivise providers to transform the service and not just deliver established practices.

Spinning out MyCSP as a Joint Venture (2013) & Investigation into members' experience of civil service pension administration (2016) – MyCSP is the first mutual spun out from central government to provide pensions administration to the civil service. The 2013 report sets out the set-up of the deal, while the 2016 report highlights the causes behind performance problems arising after MyCSP took over delivery of pension payments.

Companies in Government (2015) – This report shows how the number of companies in government has increased while other public bodies have decreased. Despite this there is no set approvals process for establishing companies (unlike other models such as mutuals) and no guidance on when a company is the best model to use.

