



National Audit Office

Principles paper

by the National Audit Office

Deciding prices in public
services markets: principles
for value for money

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Summary

This report is to help public bodies that provide public services using market mechanisms

The taxpayer pays for these services; government buys them from the market. We examine how government decides the price to pay for these services. To achieve value for money, government must decide prices for services (for example, for an hour of nursery education, or a week's stay in a care home) that are neither too high (that risk wasting taxpayer's money), nor too low (that risk impairing quality or under-provision in the market).

Public services being 'marketised'

1 Around £1 in every £3 of taxpayers' money spent on public services now goes to non-public-sector providers, in sectors such as health and social care, education, welfare, and criminal justice. The government's *Open Public Services* white paper signalled its intention to introduce user choice and provider competition across a wider range of public services. The government is committed to personalisation and public services provided through markets, rather than more traditional forms of public service provision. It will continue with plans to extend personal budgets into healthcare (for certain longer-term conditions) and special needs education.

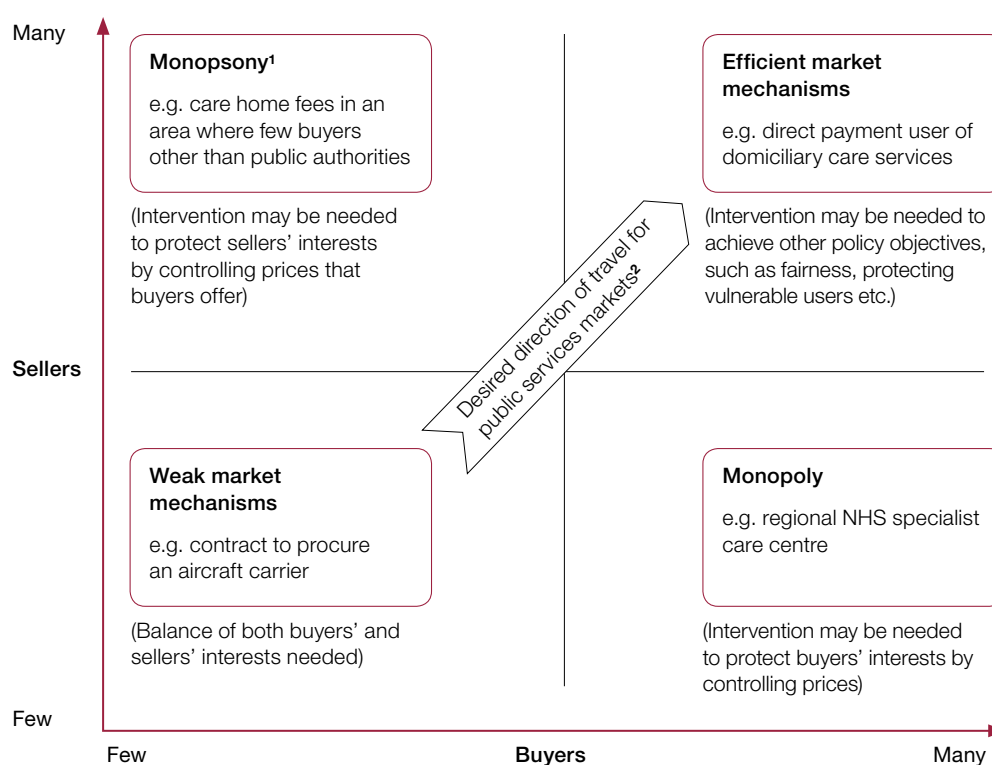
Opportunities and risks

2 Markets present opportunities for services to become more personalised, responsive, efficient, diverse and innovative. They also present new challenges for government; specifically the risk that having established markets in public services, departments and local authorities may lack the capability to ensure that they operate in the interests of the users and the taxpayer, rather than in the interests of the providers whose profits are funded by users and taxpayers.

3 **Figure 1** shows the different types of market situation that the government may face in running public services. It shows how it may need to intervene to ensure that policy objectives are met. **Figure 2** overleaf shows how markets vary in how far choice is devolved to service users, and whether the market of service providers is a local or a more national one. Much public sector engagement with the private sector takes the form of contracting and procurement (bottom left quadrant of Figure 1). However the government's role in markets goes well beyond contracting. This report is focused on where government uses markets to deliver public services like social care and early years childcare where users are entitled to choose the provider from those in the market. This report examines how prices are set in these markets.

Figure 1

Public services markets need different oversight, depending on the effectiveness of competition in the market



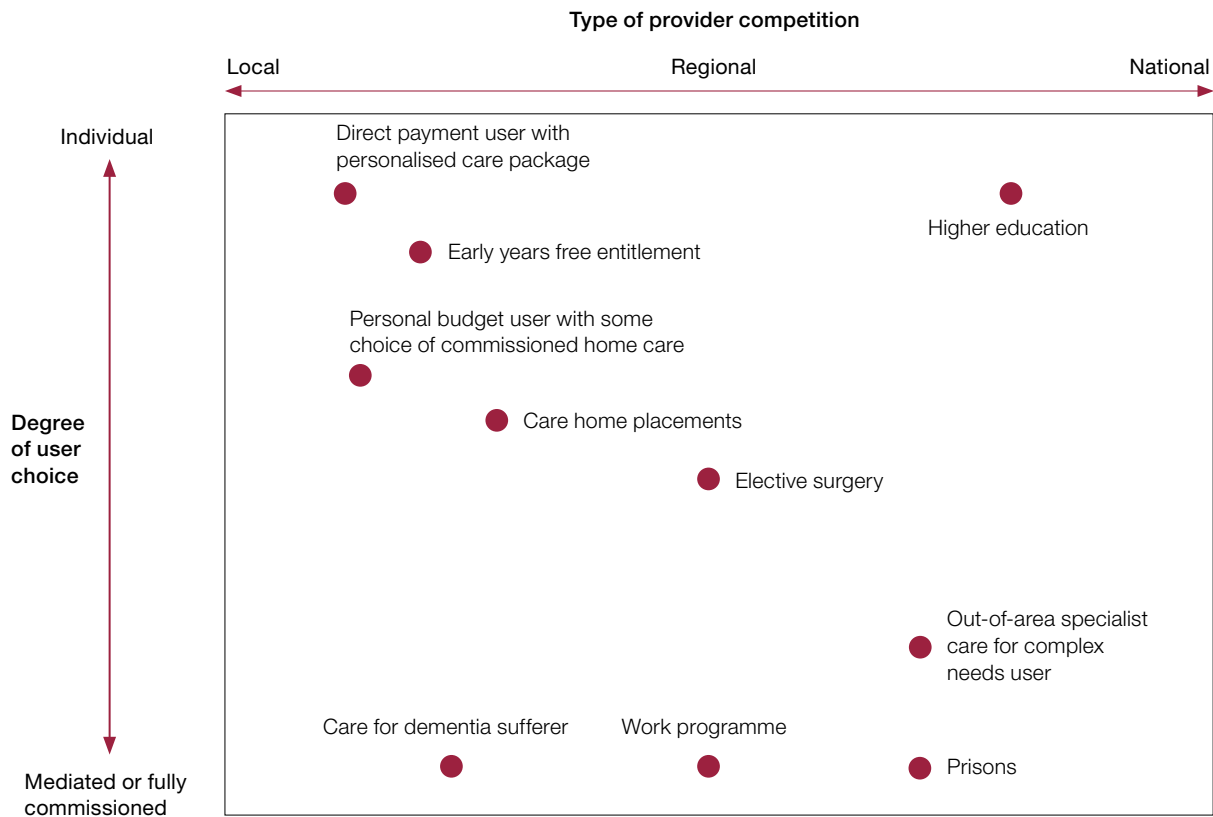
Notes

- 1 Monopsony describes a market where a single buyer substantially controls the market as the major purchaser of goods or services.
- 2 Achieved by encouraging new entry, sustaining a range of providers, increasing choice and personalisation.

Source: National Audit Office

Figure 2

Public services markets vary greatly, and differ in how far user choice and provider competition is devolved



Source: National Audit Office

4 When public bodies oversee such markets, they generally try to prevent sellers from achieving sufficient scale to achieve monopoly-type power overpricing. This could raise the cost of provision to excessively high levels. Yet the purchasing power of local authorities is such that in principle they too could face incentives to exploit their position by offering rates that may in fact prove to be too low to give providers a sustainable return in the longer term. Where providers cannot make up the shortfall from their private customers, the market may not respond well to demand pressure, and be vulnerable to financial shocks.

5 The government has statutory duties to provide services and ensure their continuity. Achieving value for money from services purchased from non-public-sector providers, therefore, is not just a matter of driving down prices. The government must maintain a market that is attractive to potential entrants and rewards good performance, and with competition that is sufficiently resilient to survive individual providers exiting the market.

The roles of government nationally and locally

6 Having market models of service provision does not mean that departments' responsibilities for achieving policy objectives cost-effectively are being diluted. Yet market delivery involves provision by non-public-sector entities, which are not directly accountable to the department that funds them. This lack of influence means that departments responsible for the policy must design the legislative framework of rules for that market, and monitor its overall financial sustainability. They must intervene as 'system operator' where appropriate to calibrate central funding, depending on the national balance of supply and demand.

7 Local authorities play a more direct 'market stewardship' role, in ensuring the market for provision operates effectively in their jurisdiction. They commission services from private- or third-sector providers, and oversee the local market (in which the authority may also be one of the providers) to ensure that levels of service provision meet their statutory duties. They act as a contact point for all providers receiving funding. They are important as they support private- and third-sector providers to achieve sufficient localised provision and promote best practice.

Paying the right price for services

8 In personalised public services, individual service users make their own purchasing decisions (such as which personal care assistant, clinic for elective surgery, or nursery place will receive funding). They do so usually without knowledge of the price of the service they are purchasing. The government intends that users are empowered to choose public services on the basis of quality, not price. This means that users' choices do not necessarily drive market prices towards efficient levels, in the way they are presumed to do in well-functioning private markets. It is difficult for the government to determine an 'efficient' price or rate for public services where prices are not transparent, as it seeks to extend choice and involve 'for-profit' and third-sector providers in delivering public services.

9 Adding to the complexity that local authorities face is the centrally determined need to balance public services' funding in a tight fiscal climate, with encouraging a healthy and sustainable local market. Reconciling these objectives is difficult, and given the shift in procurement models, local authorities may lack the experience to do so effectively.

Value for money of deciding appropriate prices

10 The report outlines eight key principles that should help to promote value for money. We chose two sectors – social care¹ and early years education – to study in detail, and also examined the evidence from a pilot of personal health budgets. As well as systematically reviewing practice in setting prices in these sectors, we used our previous work on public services markets:

- *Delivering public services through markets: principles for achieving value for money*, June 2012, outlines principles for the government to oversee public service markets and draws heavily on our back-catalogue reports, and those of the Committee of Public Accounts.²
- *Delivering the free entitlement to education for three- and four-year-olds*, February 2012, examined whether the Department for Education was achieving value for money in providing the free entitlement to education.³
- *Oversight of user choice and provider competition in care markets*, September 2011, examined how well the Department for Health oversees markets for social care.⁴

Delivering public services through markets

11 Our previous report examined how to achieve value for money in relatively well-established public markets.⁵ It focused on the requirements for getting the supply and demand sides of the market to work well. It also drew attention to the need for government to have the right skills to exercise oversight of the market effectively. Based on the evidence in this paper we have developed eight principles to help government obtain value for money for the prices in public markets, including those that do not have an 'efficient' supply and demand structure. As Figure 1 shows, public services markets can be relatively unbalanced in terms of overall provider and purchaser market power. In such cases, the government should actively intervene, so prices are efficient (as well as, when appropriate, attempting to grow and encourage the market towards being more balanced). In addition, the National Audit Office and Committee of Public Accounts have recently drawn attention to wider factors that influence government's relationship with private sector providers and the onus it places on such providers to establish and maintain a reputation for fair-dealing with government which goes beyond the formal contractual requirements.⁶

Eight principles for value for money when deciding prices for public services in markets

National principles – policy departments as ‘system operators’

12 Central departments ensure that system-wide the provision of public services is effective and is achieving policy objectives. When policy is implemented by ‘marketised’ service provision, departments need to oversee, nationally, how local authorities provide services, and have a ‘system operator’ type role:

Principle one: The relevant department understands national supply and demand and intervenes to remedy problems

This includes: the patterns of regional variation (including levels of spare capacity); the likely impact of policy reforms; and possible future scenarios.

Example: The government decided to extend early years entitlement to two-year-olds from deprived backgrounds. To implement this policy the Department for Education enabled local authorities to fund providers at a higher rate to reflect the lower adult:child ratios required for two-year-olds as opposed to three- and four-year-olds.

Principle two: The relevant department understands the national market structure and intervenes in the event of market failure

This understanding should include: market size and concentration (including ‘difficult to replace’ providers); degree of exposure to publicly funded users, and price and quality variations and trends.

Example: Since the collapse of care home operator Southern Cross, the four largest operators’ share of the market represents around 15 per cent of provision of care home beds.⁷ Three of the four largest operators have or had significantly higher than average proportions of publicly funded residents. Each has reported a significant decline in profit margins as a percentage of revenue since 2010, while the operating profitability of the operator with more private payers remained above 30 per cent.⁸

Principle three: The relevant department should understand the role of, and work with, the competition authorities and relevant quality and sector regulators, to raise awareness, standards and enforce rules and the right market behaviour

Example: The Office of Fair Trading (OFT) and the Competition Commission (who will merge to form the Competition and Markets Authority from April 2014) have a role in ensuring competition operates effectively in private and public markets. For example in 2012 the OFT wrote to several NHS trusts with private patient units to highlight rules governing competition in markets.

Local principles – local authorities as ‘market stewards’

13 Local authorities must ensure that local service provision is sufficient, and have arrangements in place that guarantee service continuity, while developing the local market to sustain long-term quality provision. To help achieve value for money local authorities should adhere to the following principles:

Principle four: The local authority understands its impact on local public and private markets as a purchaser of services, and how to encourage the right market behaviour

Example: Some local authorities have agreements with local NHS commissioners to contract for residential places on their behalf. This can have the benefit of increasing the local authority’s buying power in the local market and potentially achieve better prices for residential placements than otherwise would be possible. It avoids the two public sector buyers competing against each other in the same market. For example, for illustrative purposes the difference between the cost of the long-stay payment for a patient in hospital and the fee for a nursing home can be over £700 per week.⁹

Principle five: The local authority knows the costs of service provision

Example: Some local authorities have used an open-book approach and employed an independent ‘honest broker’.¹⁰ They have found that it helped to increase engagement with the local provider sector and that they understand better the costs of local provision in their area.

Principle six: The price sustains supply at acceptable levels

Example: In recent years public services markets have seen a few large-scale publicly listed companies exit the market, because of financial difficulties such as unsustainable business models or financial difficulties of overseas parent companies. Some local authorities we interviewed do routine credit checks on providers they commission significant levels of business from to help them gain assurance on their continuing financial viability and the sustainability of provision.

Principle seven: Quality is acceptable

Example: There can be considerable time (in some cases up to a few years) between inspections of providers by the national quality regulators. Local authorities gather their own on-going intelligence and contractual monitoring of the quality of provision to help fulfil their statutory duties and protect users.

Principle eight: Users are well informed about quality

Example: With the demise of the care quality regulator's system of differential ratings of care providers, some local authorities have made public their own care inspection ratings of local providers to help better inform users' choices and give authorities the assurance on whether their funded provision is value for money.