National Audit Office

Report
by the Comptroller
and Auditor General

Cross-government

Outcome-based payment schemes: government's use of payment by results

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Summary

1 The UK government is increasingly using outcome-based payment schemes – often called 'payment by results' (PbR) – to deliver public services. PbR is a mechanism where all or part of the payment depends on the provider achieving outcomes specified by the commissioner. Providers are, to a greater or lesser extent, free to choose the interventions needed to secure the desired outcomes.

Government use of PbR

2 PbR is not a new mechanism, but its use has increased in recent years as part of government's wider reforms to public services, set out in the Cabinet Office's 2011 white paper:

> "Open commissioning and payment by results are critical to open public services … Payment by results will build yet more accountability into the system – creating a direct financial incentive to focus on what works, but also encouraging providers to find better ways of delivering services."[1]

3 In the public sector, PbR tends to be used to address complex social issues for which there are no straightforward solutions: for example, getting people on benefits back into work, and reducing reoffending.

Scope of this report

4 This report highlights lessons on the selection and implementation of PbR in the UK public sector. Its intended main audience is commissioners and senior decision-makers within departments, as well as officials at the centre of government with an interest in public service delivery models.

5 We refer to findings from previous published National Audit Office (NAO) reports on the use of PbR for welfare-to-work (DWP's Work Programme), and family support (DCLG and DWP's programmes).[2] We also draw on NAO research on the MoJ's offender rehabilitation pilots (the precursor to Transforming Rehabilitation),[3] and DFID's use of PbR in international development. Although our evidence is mainly drawn from central government PbR schemes, our findings will also be relevant for local commissioners considering using PbR.

1 HM Government, *Open Public Services White Paper*, Cm 8145, July 2011, paragraphs 5.4, 5.16.
2 European Social Fund support for Families with Multiple Problems (DWP); cross-government Troubled Families Programme (led by DCLG).
3 We do not look at Transforming Rehabilitation in this report, but will return to it in future work.

6 Most operational PbR schemes have still to finish so there is not yet enough evidence to evaluate the effectiveness of either individual schemes or the PbR mechanism itself.

7 This report looks at:

- government's use of PbR for public service delivery (Part One);
- the issues commissioners should consider when deciding whether or not to use PbR (Part Two);
- challenges in designing PbR schemes (Part Three); and
- how government evaluates the effectiveness of PbR schemes, and the PbR mechanism (Part Four).

We have also published a PbR analytical framework. This sets out questions for commissioners that are intended to help them decide when to use PbR, and design and implement PbR schemes.[4]

Lessons for commissioners

Choosing PbR

8 PbR is not suited to all public services. In 2011, government reviewed existing PbR schemes across government and undertook some work to identify areas suited to the use of PbR. It has not updated this to reflect more recent experience in practice. The nature of PbR means it is most likely to succeed if the operating environment has certain features, for example results that can be measured and attributed to providers' interventions. If PbR is applied inappropriately there is a risk that either service quality or value for money may be undermined. When commissioners use PbR for a service to which it is not ideally suited, they need to do so knowingly and take steps to address the consequent risks as far as possible through scheme design (paragraphs 1.9 and 2.4 to 2.6).

9 Commissioners should justify their selection of PbR over alternative delivery mechanisms. Commissioners should consider a range of delivery approaches and ensure they understand the reasons for selecting PbR over alternatives. Where commissioners do identify the reasons for using PbR, as was the case in DFID's scheme to support Rwandan education, it ensures the choice of PbR is open to scrutiny, and helps inform future decisions about PbR's use (paragraphs 2.2 to 2.3).

4 This framework is available at: www.nao.org.uk/payment-by-results

10 **PbR is a technically challenging form of contracting, and has attendant costs and risks that government has often underestimated**. It is difficult to design an effective payment mechanism and forecast the level of performance that would occur without intervention. Furthermore, although PbR transfers some risk to the provider, commissioners need to be aware of the risks they retain, for example that providers fail to meet scheme objectives. In the rush to implement, government has launched some PbR schemes without making best use of pilots to test the planned approach. Commissioners need to consider the time and skills required to design and manage a PbR contract effectively, as underinvestment on these can have negative consequences for the scheme (paragraphs 2.11 to 2.13 and 3.1).

Designing a PbR scheme

11 **To get scheme design right commissioners need to understand potential providers' capacity to take on risk**. Departments' schemes use a range of providers to deliver services. For example, DWP contracts with large 'prime' providers for the Work Programme, who in turn pass work onto smaller subcontractors (usually smaller, third sector providers). Commissioners should take opportunities at the pre-procurement stage, as DWP has, to engage with potential providers throughout the delivery chain to ensure they understand the ability and appetite of different providers to take on risks associated with PbR contracts. This understanding will help inform the design of schemes, including the appropriate balance between PbR and non-outcome based payments, such as 'fee for service' (paragraphs 3.11 to 3.17).

12 **It takes time and effort to design the payment mechanism so it offers appropriate incentives to providers**. Commissioners must understand providers' costs in order to create a payment mechanism that offers an incentive to achieve the desired outcomes. If the payment offered is too high, the taxpayer could pay too much for the service; if too low, providers may not bid for the contract. A poorly designed scheme may create perverse incentives for providers, such as welfare-to-work providers prioritising people who are easier to help and 'parking' those who are harder to help. On the Work Programme, DWP uses differential payments for different groups as one way of mitigating this, although experience shows differential payments can be hard to set at the right level (paragraphs 3.19 to 3.25).

13 **It is essential that commissioners establish performance expectations at the start of a scheme, taking into account baseline performance and non-intervention rates**. Commissioners should aim to define attainable but stretching performance expectations for providers that are above the non-intervention rate (the level of performance that would occur without intervention). This avoids payment for performance that would have occurred anyway. Commissioners need good data on baseline performance, and to carry out robust modelling of likely future performance and sensitivity testing of any assumptions underpinning estimates. Where the commissioner is using PbR for a new service, such as international aid, the lack of historic, comparable data can make this especially challenging (paragraphs 3.5 to 3.7).

Monitoring and evaluation

14 Commissioners need to actively monitor and manage provider performance. Using PbR does not remove commissioners' responsibility for overseeing providers' performance; poor performance can have a negative impact on service quality, the scheme's overall objectives and the commissioner's reputation. Commissioners need accurate, reliable and timely information on outcomes achieved, and the number of participants attached to the programme, to ensure providers are only paid for results achieved. Good performance information systems can also give early indications of underperformance or undesired provider behaviour (paragraphs 4.7 to 4.10).

15 Commissioners need to plan at the outset how they will evaluate both the effectiveness of the scheme as a whole, and the impact of PbR as a delivery mechanism. Good evaluation requires commissioners to establish a robust counterfactual before implementation begins. To date, only a few schemes have monitored performance against a counterfactual, for example MoJ's offender rehabilitation pilot in Peterborough and DFID's Girls' Education Challenge. Failure to evaluate schemes means opportunities are missed to gather evidence on the effectiveness of PbR (paragraphs 4.11 to 4.15).

Conclusion

16 While supporters argue that by its nature PbR offers value for money, PbR contracts are hard to get right, which makes them risky and costly for commissioners. If PbR can deliver the benefits its supporters claim – such as innovative solutions to intractable problems – then the increased cost and risk may be justified, but this requires credible evidence. Without such evidence, commissioners may be using PbR in circumstances to which it is ill-suited, with a consequent negative impact on value for money.

17 Government has a growing portfolio of PbR schemes and the Work Programme, one of its largest programmes, has now been running for 4 years. In that time, DWP has made iterative improvements to its approach, offering government as a whole the opportunity to learn lessons for the wider use of PbR. However, neither the Cabinet Office nor HM Treasury currently monitors how PbR is operating across government. Nor is there a systematic collection or evaluation of information about how effectively PbR is working. Without a central repository of knowledge and a strong evidence base to refer to, PbR schemes may be poorly designed and implemented and commissioners are in danger of 'reinventing the wheel' for each new scheme. If PbR is used inappropriately or is executed badly, the credibility of a potentially valuable mechanism may be undermined.

Recommendations

For commissioners

18 **Figure 1** overleaf summarises our framework for assessing PbR schemes, which presents the good practice principles we recommend commissioners follow when using PbR or similar outcome-based payment schemes.

For the centre of government

19 The Cabinet Office and HM Treasury, as the centre of government, should identify a part of government to be the repository of information and expertise about public sector use of PbR. This central PbR function (which could be located in a central department or a delivery department that uses PbR extensively) should support the effective use of PbR across government by:

- identifying and sharing good practice and learning about the design and implementation of PbR schemes;
- developing government's knowledge about when PbR is most likely to be effective;
- providing guidance on the evaluation of PbR schemes and PbR as a delivery mechanism;
- facilitating networking among PbR commissioners; and
- identifying overlaps between individual schemes and coordinating efforts to eliminate duplication.

20 The central function should also gather evidence for the effectiveness of PbR by compiling data on:

- the extent to which PbR delivers the expected benefits; and
- the value for money of PbR schemes compared with alternative delivery mechanisms.

Figure 1

Summary of National Audit Office framework for PbR schemes

Key question	Aim for commissioners	What does good look like?
Overall fit: should you use PbR to deliver this service?	Commissioners only use PbR to deliver public services when it is the model that offers best value.	Commissioners' decisions to use PbR are well-informed and based on: • clearly defined programme objectives; • a good understanding of the circumstances in which PbR has worked best in the past (and, conversely, when it has been difficult to use successfully); • clarity about the benefits PbR is intended to bring to the programme at hand; and • knowledge of the whole-life costs and risks associated with using PbR, and the extent to which the scheme design will be able to mitigate these.
Design: how can you design an effective PbR scheme?	Commissioners develop insight into the operating context before designing their PbR scheme and set clear expectations for performance. Commissioners identify challenging but achievable outcomes on which to base payments. These in turn produce effective incentives for providers.	Commissioners have a good understanding of: • service users/beneficiaries and their needs; • the delivery chain for the service; and • delivery, financial and other risks within the system and how they will be allocated through the delivery chain, ensuring risks retained by the commissioner are within their stated risk appetite for the programme. Commissioners set expectations of the likely impact of PbR on: • overall service performance (eg through modelling); and • individual user outcomes (eg to avoid perverse incentives that might adversely affect long-term outcomes). Commissioners design their PbR mechanism bearing in mind the need: • to translate their objectives into measurable outcomes; • to structure payments to create appropriate incentives for providers, so the highest payments are matched to the 'best' behaviours or outcomes; and • for payments to reflect providers' cost base.
Implementation: what do you need to have in place to implement your PbR scheme effectively?	Commissioners are able to monitor the performance of providers and establish clear oversight and intervention mechanisms to minimise the impact of provider failure on public services.	This requires good performance data systems, including ways to independently verify reported performance, to: • minimise delays between achieving results and disbursing payments; • identify emerging risks to the scheme, either those at individual provider level (eg significant financial problems that might affect services) or wider risks that could threaten achievement of overall objectives; and • mitigate these risks whenever possible. Commissioners: • ensure all parties are clear about their responsibilities; and • understand what constitutes underperformance and how to address it promptly.
Evaluation: how can you evaluate the effectiveness of a PbR scheme?	Commissioners evaluate how using PbR has improved service delivery and overall value for money.	Commissioners are mindful of the need to evaluate the effectiveness of PbR schemes from the outset, ensuring the necessary elements are included at the design stage (eg a baseline and an appropriate counterfactual). Evaluation is used both to make iterative service improvements during the life of a scheme and to identify lessons learned at the end. This should cover the scheme as a whole, as well as the effectiveness of the PbR mechanism itself.

Note

1 For more information, the full framework is available at: www.nao.org.uk/payment-by-results

Source: National Audit Office