National Audit Office

Report
by the Comptroller
and Auditor General

Principles Paper: Managing provider failure

HC 89 SESSION 2015-16 21 JULY 2015

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National Audit Office

Principles Paper: Managing provider failure

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 21 July 2015

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act

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14 July 2015

HC 89 | £10.00

This paper explores the principles departments should use to manage provider failure. We define a provider as any organisation that delivers services to or on behalf of government and failure as any event which requires an intervention above and beyond normal performance management.

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Summary

About this paper

1 Many organisations provide public services, and sometimes these organisations fail. The failure of a provider is not necessarily something that should be avoided at all costs. It 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. 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.

2 Managing the failure of a provider can be difficult. Departments may at times need to move quickly to respond to changing external pressures or new ministerial priorities. However, departments will be best placed to minimise negative impacts if they have planned how they would respond to a failure. Planning should start with deciding how a public service will be provided – by a public sector body, through a contract, via a market or by another approach, which should be informed by how much risk of failure a department is willing to tolerate.

3 It can be very difficult to decide how much risk to transfer to providers, and how such risk transfers will work in reality, given that the department retains ultimate responsibility for providing a service. We have seen many instances where departments believed that in contracting out services they had transferred the risks to the provider through financial penalties. But when a contract fails the provider can walk away, and government cannot. Departments have to recognise this position and refine their judgements on these and many other issues as they proceed.

4 There can also be a difference between a department's stated and revealed appetite for the failure of a provider. For example, market mechanisms and payment by results can seem significantly more politically attractive when they are introduced (and offer the potential for lower costs and improved outcomes through competition) than when they result in providers leaving the market. Failure regimes have often been established, but we have observed very few occasions when government allowed providers to actually fail. This change in risk appetite can be exacerbated by the 24 hour news cycle and the role of social media, which provide both an opportunity for departments to access unfiltered public feedback on a provider, and a challenge as failures unfold quickly and publicly, generating demands for instant action in complex situations.

5 In our experience, departments are very rarely able to specify at the beginning of a programme everything that they will require over its lifetime. There are practical steps departments can take to increase the flexibility they have to introduce changes, but these will come at a cost. In the past, we have seen departments jeopardise value for money by entering into long term but inflexible agreements, which need to be revisited part way through at significantly increased cost.

6 We have also observed that government has a poor record of learning from past failures. Departments face similar issues and often make similar mistakes in designing failure regimes. We have identified, over a number of reports, the need for government to take a more coordinated approach to learning about delivery models and this is especially true when thinking about this topic.

7 This principles paper draws on a review of our previous work, a wide ranging literature review and interviews with stakeholders across the private, public and third sectors. It sets out principles departments should consider when planning for and managing failure. We have included case studies to show how applying these principles can either assist departments in attaining ministerial objectives or, if they fail to apply them, lead to failing to achieve those objectives and reputational damage. Badly managed failure can discredit particular models of providing public services. It can also harm the users' interests, either because they experience a break in services or anxiety about losing their service. **Figure 1** overleaf sets out the structure of the rest of this paper.

Figure 1
Report structure

	Elements of the definition
Provider failure definition (Part One)	Providers Organisations that provide services to or on behalf of government departments. They can come from any sector. Failure Any situation requiring intervention above and beyond normal performance management.
Our principles	
Strategy and Planning (Part Two)	**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 (Part Three)	**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 (Part Four)	**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: National Audit Office analysis

Part One

Context

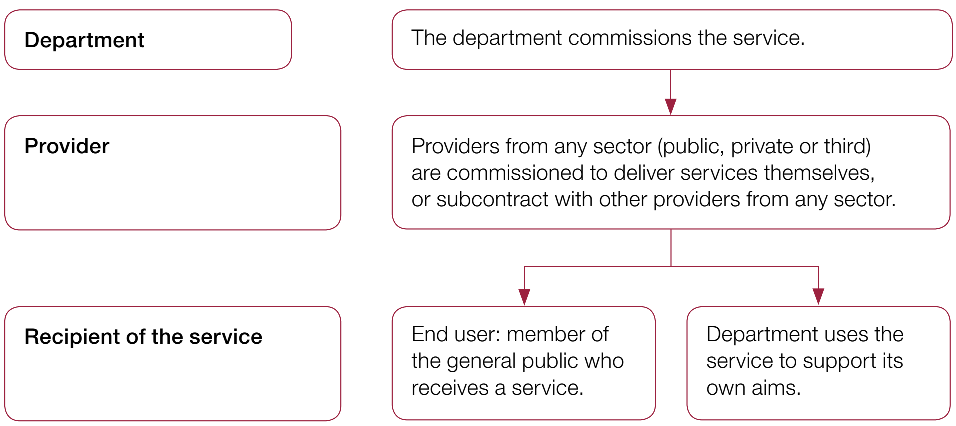
1.1 This part describes:

- what provider failure is; and
- why it is increasingly important.

What is a provider?

1.2 In this guide, a provider is any organisation that provides a service to or on behalf of government. This can include a contractor that provides an IT system for a government department, an arm's-length body managing delivery and a hospital providing services to a local community. It includes providers from the private sector, charities and the public sector. Providers may work directly with a department or be subcontracted under another provider to provide part of a service (**Figure 2**). Although it is not the focus of this guide, government may on occasion also need to manage the failure of a provider that does not provide services to or on behalf of government. For example, government intervened to manage the nationalisation of Northern Rock, because of risk of instability in the financial system.[1]

Figure 2
What counts as a provider



Source: National Audit Office analysis

1 Comptroller and Auditor General, HM Treasury, *The Nationalisation of Northern Rock*, Session 2008-09, HC 298, National Audit Office, March 2009.

1.3 We draw mainly in this paper on examples from our previous work on commissioning within departments. However, the lessons are relevant to all public sector commissioners, including local authorities, police and crime commissioners and the NHS.

What we mean by failure

1.4 In this paper, failure is any situation requiring an intervention above and beyond normal performance management. This may include the provider:

- not providing a service for financial reasons (financial failure);
- not governing itself according to public expectations (governance failure); or
- not meeting an expected minimum performance standard (performance failure).

Departments will need to define the particular dimensions of provider failure in their sector. In many cases, departments will find it easy to define failure. In others departments will need to define the boundary between underperformance and failure. In doing so they will need to consider how far they will let a provider deal with a failure in performance through internal mechanisms and when they should step in.

1.5 Departments may also need to consider how to handle a provider exiting a market for reasons other than failure. This could happen if, as a commercial entity, the provider does not feel there are enough opportunities for profit.

A changing delivery landscape

1.6 Provider failure is a more important issue now because of the open public services agenda (**Figure 3**).[2] Increasing the amount of innovation in public service delivery models has the potential to deliver better public services at lower costs, but it also increases the risks of failure.

1.7 Even with opening up public services, government is responsible for failure and for the system as a whole, and it has intervened in the activities of providers; for example, intervening in local schools in Birmingham following allegations arising from the 'Trojan Horse' letter. Local authorities are primarily accountable to a local electorate, however the Department for Communities and Local Government has intervened in instances where there were serious failures; for example the Department appointed commissioners to oversee certain functions in Tower Hamlets Council following irregularities in the controls over expenditure of public money. The Committee of Public Accounts expects accounting officers to discharge their responsibilities to Parliament for public services, even when services are contracted out.[3]

2 Cabinet Office, *Open public services white paper*, Cm 8145, July, 2011.
3 HC Committee of Public Accounts, *Accountability for public money*, Twenty-eighth Report of Session 2010-11, HC 740, April 2011.

Figure 3
How changes in public service provision have increased the risk of provider failure

Change	Consequence for failure
Greater devolution of power to public bodies, local authorities, private and charitable organisations.	Providers have greater independence from departments to make decisions; increasing the risk of unforeseen performance, financial or governance failure.
Greater diversity of providers such as charities and private sector companies.	These entities will be affected by events outside of the public sector, and outside of government control, such as takeovers and changes in economic conditions. Such events may affect their financial viability and attitude to their responsibilities to the public sector.
Increasing use of provision models such as markets and payment by results.	These models rely upon the prospect of failure to incentivise providers to perform well and to discard providers who do not.

Source: National Audit Office analysis

1.8 Since public services have been opened up, consolidation of the market has led to a number of providers developing large portfolios of work with several departments. Should one of these providers fail, the consequences would be experienced by a number of different departments and by many different users. Government as a whole has set up mechanisms to manage commercial providers at the centre through the Crown Commercial Service and the Crown Representatives.

1.9 These principles are intended to support departments in balancing their aim to transfer responsibility for operational delivery to providers while retaining their accountability to Parliament and users of public services.

Part Two

Strategy and Planning

2.1 This part sets out what departments should think about when planning for failure:

- Strategy: appetite for failure.
- Planning:
  - selecting the delivery model; and
  - planning for the event of a failure.

Strategy: the appetite for failure

2.2 The department should set out its definition of failure in its plan (paragraph 1.4). It should then define its appetite for failure. The consequences of a provider failing will be much more serious in some circumstances than others. In some cases, government may not wish to tolerate any performance failure. In others, departments may be able to design contingency plans that allow for the failure of a provider without a significant impact on service users. We have identified some of the factors to consider when assessing the likely impact of a failure, and therefore how great a risk of failure to design into a delivery model (**Figure 4**).

2.3 Departments might choose to use different types of information to assess their level of exposure to failure. They could include: feedback from potential users; academic studies of potential users; provider forums; scenario testing; evaluations of previous programmes; or consultations. They may also need to consider the political implications of failure.

2.4 The appetite for failure may change as policy priorities or a delivery area evolves, and the factors affecting the impact of a failure may also change over time, as may a department's view of them. In which case, departments may have to update plans for preventing and managing failure. When a department introduces a new policy, it should consider how this affects the sector concerned, including established providers (**Figure 5**), as well as considering how it will affect its other policy priorities.

Figure 4
Factors to consider in assessing the likely impact of failure

Factor	Circumstance with a likely low impact of failure	Circumstance with a likely high impact of failure
User dependence on the provider	Provider provides an occasional and non-essential service to users. The user can easily shop around for a better service if needed.	The provider provides an ongoing or essential service that may contain elements of personalisation.
User Vulnerability	The user could complain about poor service and obtain redress.	User unable because of their situation to complain or get redress to adequately compensate them.
Service continuity	Department can easily supply the user with a new provider or the user can select one easily. This will happen before the user is harmed by the removal of the service.	Only one available provider so when it fails, the user cannot find another. The user may suffer little short-term harm, but they are adversely affected long term as they lack provision.
Impact on other service provision	Provider's failure causes no knock on effects on the service overall and users of other providers are unaffected.	Provider's failure causes a wave of other failures. Users of other providers are significantly harmed.
Departmental policy priorities	Provider's failure has little impact on the department's priorities and causes little public embarrassment.	Provider's failure greatly affects how well the department secures its policy priorities.
Departmental finances	Negligible cost of the provider's failure for the department.	The department faces a large cost should the provider fail.

Source: National Audit Office analysis

Figure 5
Changing appetite for failure

The university sector

We reported in 2011 on financial sustainability in the university sector. The Higher Education Funding Council is responsible for regulating financial sustainability in the publicly funded part of the sector. We assessed its approach as cost effective and concluded it had had three positive impacts: no university had failed since 1993; lenders were more confident about lending to the sector because of its successful regulation; and it was cost efficient.

However, we also noted that government announced major policy changes which changed both the potential level of funding and its source, introducing potentially more uncertainty and risk into the system. It decided to open up the market to allow a more diverse range of providers and allow universities to charge higher fees. Should they not attract enough students, there would be a risk that the university would fail. We noted that the Council would have to adjust to dealing with institutions that faced more short-term risk of financial failure and would have to do more monitoring in the future and we feared that it might find itself 'stretched'. The Council at the time was adjusting its regulatory framework and approach to procedures in line with government's change in policy and for the increased risk of failure.

In this case, no universities failed. However, when a department introduces an innovative funding mechanism, it should attempt to understand how it will affect the finances of providers.

Source: Comptroller and Auditor General, *Regulating financial sustainability in higher education*, Session 2010-11, HC 816, National Audit Office, March 2011

Planning

Selecting a delivery model

2.5 Different service delivery models imply different appetites for failure. It is therefore important for the department to choose a delivery model consistent with their appetite for failure. Some delivery models, such as markets or payment by results, involve providers being incentivised by a risk of financial failure. As we stated in our report on social care markets, "the risk of going out of business can act as a powerful incentive on providers to continue to perform well."[4] But departments will need to be conscious of the extent to which there is political will to allow a provider to fail as this can often be a key consideration when a provider failure occurs. In other models, where the department closely manages delivery, providers have less latitude to fail. However, this may also mean the provider has less room to innovate or that government is paying a premium for the service because the price it is paying includes a 'risk premium', but it is not actually transferring very much risk.

2.6 We have seen a number of instances where failure regimes have been set up but on relatively few occasions has government allowed providers to actually fail. Based on our experience, departments will need to carefully think through how they would respond to a failure before assuming they have a high appetite for it. The clearer and more accurate departments can be about their appetite for failure before starting a programme, the more able they will be to select the correct delivery model. If a department has a high tolerance for failure, it can focus its efforts on managing the system or market as a whole, and may not need to monitor individual providers.

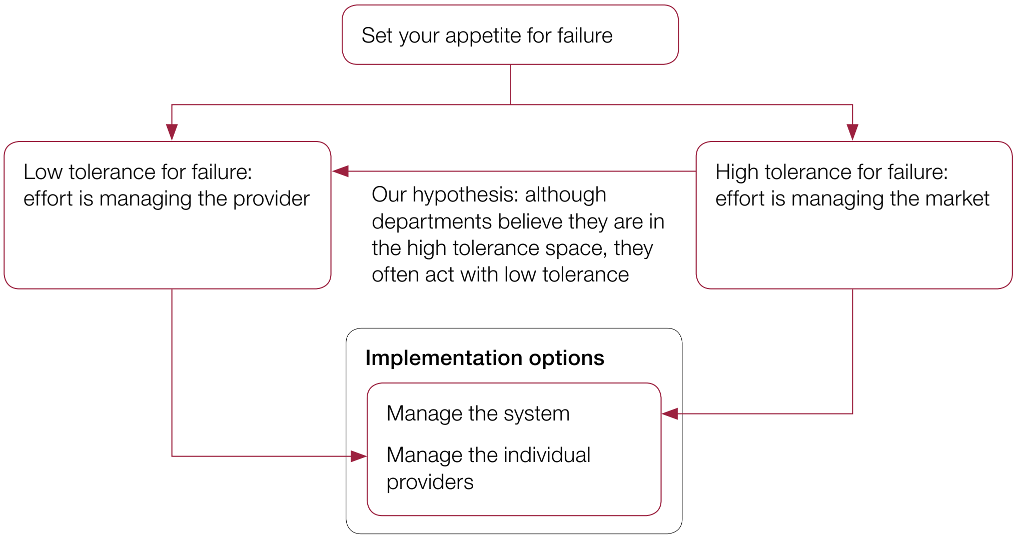
2.7 Alternatively, if a department has a low appetite for failure (the failure of any individual provider would have serious consequences), then it is important to monitor individual providers. There is a risk that departments might initially think they have a high appetite for failure and so manage the system as a whole, but when an individual provider looks like it will fail, they rethink (and lower) their risk appetite (**Figure 6**).

2.8 Different delivery models have different advantages and constraints, and to get the best from them, it is important that departments have people with the skills to manage them effectively. We have found in the past that contract management has been under-resourced in central government.[5] Departments may need to consider whether the model remains the most cost-effective, given the costs of monitoring and managing the market effectively.

4 Comptroller and Auditor General, *Oversight of user choice and provider competition in care markets*, Session 2010–2012, HC 1458, National Audit Office, September 2011, p. 29.

5 Comptroller and Auditor General, *Transforming government's contract management*, Session 2014-15, HC 269, National Audit Office, September 2014, p. 7.

Figure 6
How perspectives on failure can evolve



Source: National Audit Office analysis

2.9 Delivery models vary in their flexibility, which will affect options for managing a provider failure. In our experience, departments often need to manage changing priorities over the life of a programme. There are steps departments can take to increase flexibility, for example inserting break clauses into contracts. Whilst this may increase costs, it needs to be balanced against the fact that inflexible arrangements may lead to poor value for money when the department makes changes. For example, procurement rules may limit a department's flexibility to change approach during a procurement or to adjust their thinking after they have procured a service. Contract terms might constrain a department's ability to gain control of assets in an insolvency.

2.10 We have reported on procurement in government, and published guidance on good practice in contract management.[6,7] Service users may have views on the selection of a delivery model – for example, a delivery model which requires a service user to research and select one provider from a number of choices may not be appropriate for all service users in all circumstances. We have guidance on the risks and opportunities involved in the use of markets and payment by results.[8,9]

6 Comptroller and Auditor General, *Improving government procurement*, Session 2012-13, HC 996, National Audit Office, February 2013.
7 Office for government commerce and National Audit Office, *Good Practice Contract Management Framework*, National Audit Office, December 2008.
8 National Audit Office, *Delivering public services through markets; principles for achieving value for money*, National Audit Office, 2012.
9 Comptroller and Auditor General, *Outcome-based payment schemes: government's use of payment by results*, Session 2015-16, HC 86, National Audit Office, June 2015.

Designing a delivery model

2.11 Having chosen a delivery model, the next challenge is to refine it to apply to the department's particular circumstances and objectives. For example by setting prices, deciding on the amount of risk to transfer, setting a timetable or establishing what performance to expect, and how to monitor it.

2.12 **Figure 7** sets out some relevant pitfalls which can result in issues for the commissioner of a service with their providers, as our case study in **Figure 8** illustrates. As the case in Figure 8 illustrates, attempts to transfer too much risk can be self defeating as they may contribute to the failure of a provider, at which point, the risk reverts to the department.

2.13 In our experience, departments can find it difficult to fully transfer risk. Commercial entities in particular may limit their liability through the creation of special purpose vehicles which shield the main entity from excessive losses. Departments will always hold the ultimate risk because they are responsible for service delivery to the public and are usually the largest party in the agreement.

Figure 7
Challenges in adapting and refining the delivery model

Factor	What could go wrong
The department transfers the wrong amount (too much or too little) or wrong risks to the provider.	Undermines the provider's incentive to manage the risk. If too much risk is transferred providers may not be sustainable. If too little risk is transferred then providers will have little incentive to improve provision but can skim off profits.
Scheme poorly costed (by provider or department).	Providers are unable to achieve appropriate outcomes or achieve them while making excess profits. Provider may fail financially or fail to perform. We published guidance on pricing in public sector markets and on costing.[1,2]
Choosing a provider based on over-optimistic forecasting of performance.	Provider may be incapable of achieving the expected levels of performance.
The introduction of the scheme is rushed.	Introducing a scheme quickly carries risks, especially with a complex scheme. For example, if the department works with an inexperienced provider it may have to allow time for them to find out about subcontractors, experts and users to initiate their plan.
Over dependence on a provider.	The department has fewer levers to influence the provider.

Notes

1 National Audit Office and Chartered Institute of Management Accounting, *Delivering value and accountability, How finance can help*, National Audit Office, October 2014.

2 National Audit Office, *Deciding prices in public services markets: principles for value for money*, December 2013.

Source: National Audit Office analysis

Figure 8

Over-optimistic commissioning

Hinchingbrooke Hospital

In November 2011, Circle was awarded the contract to run Hinchingbrooke Hospital. We examined the contract in 2012 and found that Circle's bid was based on projected savings that, as a proportion of turnover, were unprecedented in the history of the NHS. If it failed to achieve these unprecedented savings, Circle would have to absorb the cost overruns in its budget of up to £5 million in total. The Strategic Health Authority had assessed financial risk in a limited way, when evaluating bidders' proposals, but its approach may have encouraged bidders to make overly-optimistic savings projections.

In 2015, Circle withdrew from the contract, arguing that its decision was based on three factors: the rising demand for healthcare that the trust was having to deal with; income not increasing in line with this activity; and its view that there was no immediate prospect of reform in the local health economy which would be needed to make the trust sustainable. The taxpayer was left exposed by the failure of the Hinchingbrooke franchise. The total deficit incurred during the franchise was well above the level that Circle was contractually committed to cover, leaving the taxpayer with the rest of the bill.

Sources: Comptroller and Auditor General, *The franchising of Hinchingbrooke Healthcare NHS Trust*, Session 2012-13, HC 628, National Audit Office, November 2012; HC Committee of Public Accounts, *An update on Hinchingbrooke Health Care NHS Trust*, Forty-sixth Report of Session 2014-15, HC 971, March 2015

Planning: Plan for the event of a provider failure

2.14 Failure to recognise and plan for the possibility of provider failure can leave departments exposed and give them limited scope to respond (**Figure 9** overleaf).

2.15 Departments will be better able to deal with a provider failure if they develop contingency plans. The level of detail of the planning should be proportionate to the likelihood and impact of a failure (and the department's confidence that they understand the likelihood and impact of failure). As far as possible, plans should be realistic, consistent with the chosen delivery model, focused on departmental priorities and take account of past experience (both within the department and across government).

2.16 Failure can happen very suddenly and quickly and may require resources which are not typically used in normal contractual or other forms of management to be deployed quickly. Departments will be in a far stronger position if they identify these resources in their plans, (for example legal advice, alternative providers, communications experts), and how they can be made available quickly. Where there are very specialised services, departments may be competing with others for them in a crisis.

2.17 In the event of a failure, there is likely to be a lot of uncertainty among a range of stakeholders. The department is responsible for ensuring that the service continues and stakeholders will look to the departments in the event of a provider failure. It will be easier to manage this if the department has a plan for managing communication with stakeholders, particularly the users of the service concerned, and are proactive in communicating how they will manage the situation (**Figure 10** overleaf).

Figure 9
Why it is necessary to plan for failure

Police and Crime Commissioners

In 2011, the Home Office introduced Police and Crime Commissioners (PCCs). The Home Office designed the policy to provide greater local autonomy in policing and increase local accountability by replacing unelected police authorities with elected commissioners.

Early in 2014, we examined the police accountability landscape. While we found that the Home Office had set up police and crime panels to hold PCCs to account between elections, we found they lacked the powers to act on information they received and lacked access to information, including for example detailed performance information and draft police and crime plans. We found that there was no recall process and that there were few practical checks on PCCs. We identified a risk that if serious issues arose with a commissioner's performance or conduct, it might be difficult or impossible for the local public or the police and crime panel to address them.

During 2014, it was alleged that one commissioner, Shaun Wright, in South Yorkshire, had been negligent in the safeguarding of children in Rotherham, prior to becoming Police and Crime Commissioner. There were press calls for his resignation, which the Home Secretary supported, but the Home Office had no powers to remove him. As there was no power of recall, the electorate could not remove him between elections. Mr Wright eventually resigned.

In responding to the Home Affairs Select Committee, the Home Secretary agreed that there was 'a debate to be had regarding the recall of PCCs'.

Sources: Comptroller and Auditor General, *Police accountability: Landscape review*, Session 2013-14, HC 963, National Audit Office, January 2014; HC, Home Affairs Committee, *Child sexual exploitation and the response to localised grooming: follow-up*, Sixth Report of Session 2014-15, HC 203, October 2014

Figure 10
Stakeholders and their needs when a provider fails

Stakeholder group	Possible needs when the provider fails
Users	Service continuity plan if provider exits the market. Communication plan and what actions they need to take.
Providers	Define what will happen if they fail: who will keep assets and what will happen to staff? Define how work will be affected if another provider or a prime contractor fails.
Staff	Arrangements for transferring staff if necessary to continue provision.
The department	Its legal and contractual rights (if relevant). Clear and realistic timeline to resolve a failure. Clear responsibilities for action in the event of failure. Priorities (as set out in their original strategy) for what to protect.

Source: National Audit Office analysis

2.18 In some circumstances, all providers might be at risk of failure at the same time. This may happen for example when an external event (such as a changing economic situation) affects the service's outcomes, leading to performance or financial failure for providers. Where this is the case, departments should consider how to prevent it or address it.

2.19 Due diligence work can reduce the risk of failure on beginning a relationship with a provider, but it also imposes costs and so may limit the available pool of providers. Some departments now require all providers to go through an external governance audit before they commence providing services.[10] Such checks can mitigate some risks but may also affect the number of providers available. It is very difficult to design a process that excludes all undesirable potential providers while retaining all good ones. For example, small and medium-sized enterprises may be excluded by due diligence requirements. Departments may also consider how dynamic their measures of risk for each provider are and how well they reflect the knowledge held across government about the provider. Departments will need to come to a judgement based on their appetite for risk, cost and innovation.

2.20 Government commissions from a number of large providers who hold many contracts with a variety of different departments. Consolidation of the market in this way may mean that an individual failure has consequences for many government departments and needs to be dealt with at a strategic level. Departments and government as a whole may choose to assess these providers on a portfolio basis, with a coordinated response to any potential failure. Such a response might involve prioritising where to put effort, ensuring that each commissioner is aware of their place in the overall strategy for the provider's failure and ensuring that resources are deployed effectively.

10 Comptroller and Auditor General, *Transforming government's contract management*, Session 2014-15, HC 269, National Audit Office, September 2014.

Part Three

Measurement and Implementation

3.1 This part sets out what departments might do when a programme begins. It covers:

- measurement: introducing appropriate oversight;
- Implementation:
  - Clarity with suppliers during normal operation of the programme.
  - Balancing the need to be consistent with the need to respond to changing circumstances.

Measurement: Put in place appropriate oversight arrangements

Accounting officer responsibilities

3.2 Irrespective of whether and how far services are devolved, accounting officers must satisfy themselves that they are securing good value for money from departmental spending.[11] In 2011, government committed to publishing accountability system statements. These set out the system for each department's decentralised funding so accounting officers can give assurances to Parliament. Government said that departments should set out their arrangements for dealing with failure or underperformance in these statements.[12]

3.3 Departments bear ultimate responsibility for how providers use public money. Departments must assure Parliament of the propriety and regularity with which money is spent, whether it is spent directly by a department or by a provider on their behalf. These terms are defined in guidance from HM Treasury, *Managing public money* (**Figure 11**).

11 HC Committee of Public Accounts, *Accountability for public money*, Twenty-eighth Report of Session 2010-11, HC 740, April 2011.

12 Department for Communities and Local Government, *Accountability: adapting to decentralisation*, September 2011, pp. 15, 23–24.

Figure 11
Definitions of regularity and propriety

Regularity: compliant with the relevant legislation (including EU legislation), delegated authorities and following the guidance in this document *Managing Public Money*.

Propriety: meeting high standards of public conduct, including robust governance and the relevant parliamentary expectations, especially transparency.

Source: HM Treasury, *Managing Public Money*, July 2013

Monitoring the provider

3.4 After selecting a provision model and a plan for provider failure, departments need ways to measure whether providers are at risk of failing. These need to be proportionate to departments' appetite for failure, and appropriate for their model. For example, departments may need to monitor more where the impact of a failure would be larger and its likelihood higher. They might balance this imperative with the costs of monitoring, to themselves and to providers.

3.5 There are a variety of different mechanisms departments can use to monitor risks and identify early warning signs of failure. These include requesting regular performance returns, inspection regimes, feedback from users or staff, regular discussions with providers, and many other methods. An effective monitoring regime is likely to include a mix of proactive monitoring (where the department asks for information) and reactive monitoring (where the department creates channels for people to raise concerns). **Figure 12** overleaf sets out some of their advantages and disadvantages.

3.6 Reactive monitoring can allow departments to discover 'unknown unknowns'. Sometimes whistleblowers have uncovered important abuses, so it is essential that staff and service users can communicate through these channels of communication (**Figure 13** overleaf). Monitoring systems should, as far as possible, cover the full range of activities for which departments must account to Parliament. Even where departments have set up regulators to regulate providers, they retain ultimate responsibility for the system (immediate responsibility for the provider rests with the governance systems of that provider). Regulators do not always identify provider failure so it is worth considering other types of intelligence about performance (Figure 13).

Figure 12
Types of monitoring

	Proactive monitoring	Reactive monitoring
Examples	Inspection, regulation, performance returns.	Whistleblowing, complaints.
Pros	Collecting the same information on a regular basis makes it possible to identify trends in performance. Department can require information on the areas most important to it.	Dynamic and responsive to what users and staff think. Not filtered through departments' expectations of the service so may be more likely to identify emerging risks. Independent of service provider.
Cons	It may not identify emerging risks or changes. It can be more costly than reactive monitoring.	Can be subject to bias. Unlikely to be comprehensive. Depends on the ability of the complainant to complain.

Source: National Audit Office analysis

Figure 13
Regulators do not always identify failure

Mid Staffordshire Hospital

Following concerns around safety at Mid Staffordshire NHS trust, the Department of Health commissioned Robert Francis to look at patient care, quality and safety at Mid Staffordshire as well as the role of the systems commissioning, supervisory and regulatory bodies.

The Francis Report identified persistent failures in the Mid Staffordshire Hospital trust. It highlighted that the trust's board did not identify a pattern of poor care and that the board did not deal with a management culture in which poor performance was tolerated.

The inquiry also referred to the failure of regulators to understand what happened at the hospital. Data was available which indicated an issue at the trust: for example, the mortality rates in mid Staffordshire during 2005-6 were abnormally high. However, neither the Department of Health, nor the regulators, picked up on this and took appropriate action. The Francis Report suggested that mortality rates were statistically significantly higher in Mid Staffordshire than elsewhere and media reports suggest that the cost of the reconfiguration following this failure was in the region of £220 million. The issues were only discovered because of the work of patients' groups who brought them to public attention.

The media blamed both the Department and responsible ministers for the failings of the regulatory system, the inquiry required senior officials to give evidence and cost £13,684,100. While the hospitals and regulators had some operational autonomy, Parliament focused on the Department's ultimate responsibility for health services and spending, in line with *Accountability for public money* published by the Committee of Public Accounts in 2011.

Sources: The Mid Staffordshire NHS Foundation Trust Public Inquiry, *Report of the Mid-Staffordshire NHS Foundation Trust Public Inquiry*, Session 2012-13, HC 947, February 2013; HC Committee of Public Accounts, *Accountability for public money*, Twenty-eighth Report of Session 2010–11, HC 740, April 2011

3.7 It may be necessary to adjust systems to respond to changes in risk, accepting that this may result in additional cost. For example, departments may choose to do the following:

- adopt dynamic measures which change as the service and the delivery environment evolves:
  - recognise that performance may rise over time so expected minimum service levels from a provider may change during their relationship with the department.
  - recognise the department's appetite for failure may change during a long contract or service agreement, with new ministers and senior officials having a different appetite for risk and therefore, where possible, build flexibility into agreements.
  - recognise that after a provider fails, the department may need to consider whether that changes incentives for all providers in its delivery chain (see Part Four). This may alter the department's type of monitoring.
  - raise the level of monitoring to respond to known changes in risk – for example during economic distress or periods of rising service demand and when capacity is under strain.
- change the monitoring system to reflect the expertise within the department. If departmental expertise erodes over time, the department may need to hire or consult with experts in the field, or ask for more data about performance and benchmark the data it has more effectively.

3.8 Departments will be better placed to spot emerging risks if they are able to monitor prospectively as well as retrospectively. For example, departments should monitor the projected financial performance of providers – examining income and cash flow projections – as well as the past performance of providers through accounts. Departments may choose to test their providers' forecasts for unexpected events.

3.9 A department's ability to monitor a provider and their provision of services depends on the rights it has to get information from the provider. In establishing rights to information, departments should ensure that Parliament and its auditors can follow the public pound. We have reported on open book accounting in relationships with the private sector and how to monitor for financial impropriety elsewhere.[13,14] Every major government contract needs a supply chain assurance strategy.

3.10 Effective monitoring systems may benefit providers. Lenders, for example, may take assurance from the department's monitoring systems in providing cheaper credit to providers (Figure 5 on page 11).

13 Comptroller and Auditor General, *Open-book accounting and supply-chain assurance*, Session 2015-16, HC91-I, National Audit Office, July 2015.

14 HM Treasury and National Audit Office, *Good practice in tackling external fraud*, National Audit Office, June 2008.

Implementation

Clarity with providers and users about what constitutes failure and what would happen as a consequence of it

3.11 It will be easier to identify and manage failure if departments can agree with providers and users about what constitutes failure and what happens in the event of a failure. However, we recognise that this is not straightforward to do, as what is considered to be a failure is likely to change over time, as political and public priorities shift: for example delivering a service successfully may affect expectations of that service, leading to a higher level of provision being classified as failing. Departments should be as honest as possible with providers about their changing service expectations, particularly in the context of a long-term relationship, so that providers are better able to meet those expectations.

3.12 A clear and transparent approach to sharing information about failure can help providers to deal with failure before it happens. Departments may choose to:

- share their assessment with a provider who they believe is close to failing;
- share knowledge with a provider who is close to failing about options for successfully turning around their business, including inviting another (more successful) provider to assist or mentor them;
- appoint new senior staff to a provider's board to assist them; or
- discuss emerging risks with a provider so they are better able to manage them if they materialise.

Departments may consider whether these approaches are consistent with their view of the way that failure acts as an incentive in their system. In some delivery models, such as markets, such an approach may lead to providers believing the department will not let them fail, and thus not responding to the incentive.

3.13 Different approaches will be suitable for different types of providers and departments should consider the implications of any help they give to an unsuccessful provider, in the same way as they would consider the impact of rescuing a failing provider. They should also have regard to relevant regulations such as procurement law and state aid rules. However, as we have stated in the context of commercial providers, good provider management requires effective relationship management.[15,16]

3.14 This is particularly important when several providers provide a service together. In this situation, departments should be particularly clear about where accountability lies for each part of the service. Departments should remain alert to any confusion about accountability and address it speedily (**Figure 14**).

15 Her Majesty's Inspectorate of Constabulary and National Audit Office, *Private sector partnering in the police service*, July 2013, p. 45.
16 Comptroller and Auditor General, *Transforming government's contract management*, Session 2014-15, HC 269, National Audit Office, September 2014, p. 35.

Figure 14
Addressing a lack of clarity about where accountabilities lie

Universal Credit

Our report on the introduction of Universal Credit by the Department for Work & Pensions highlighted a number of failings in the Department's management of the programme. Among these was a failure to manage the suppliers of the IT systems: the report found that it was not clear which suppliers were accountable for which elements of the system and that the Department had not adequately used its contractual rights to request and monitor financial information.

The initial issues contributed to poor press coverage for the Department, condemnation from the Committee of Public Accounts and a delay to the implementation of a flagship policy of the coalition government. Additionally the programme was reset, by a team temporarily led by the head of the Major Projects Authority.

Recognising that providers were failing to meet their targets, the Department had made changes to improve its financial management. While at the time we reported these changes were still 'bedding in' we were able to quote internal audit reviews which offered the Department substantial assurance that they had made progress, including clarifying roles and responsibilities around contract requirements and more active supplier management.

Sources: Comptroller and Auditor General, *Universal Credit: early progress*, Session 2013-14, HC 621, National Audit Office, September 2013; Comptroller and Auditor General, *Universal Credit: progress update*, Session 2014-15, HC 786, National Audit Office, November 2014

3.15 Departments may choose to discuss with providers:

- what would lead to the department suspending the service;
- what they want to safeguard;
- what legal responsibilities they have should a provider fail; and
- who will perform particular roles in the event of a failure, both inside the department and in the provider:
  - who will take decisions; and
  - who will be the point of contact for the provider, the department and for users during the process of dealing with the failure.

Responding to failure

3.16 When a failure occurs, a department will need to respond, balancing its plan, any relevant regulations (such as procurement law) and the requirements of the moment. Sometimes that response will just be monitoring service continuity for users and learning lessons, for example in a market where users can find alternative provision themselves. In others the department will need to respond more substantially to safeguard the taxpayer interest and users of the service – for example, a department might need to take over the provider and run services itself, replace senior management in the provider or fund the provider until it can source alternative provision. As we stated in our report on lessons from transport programmes, departments "must be realistic and responsive to unexpected events" in how they implement plans.[17]

17 Comptroller and Auditor General, *Lessons from major rail infrastructure programmes,* Session 2014-15, HC 267, National Audit Office, October 2014 p. 8.

3.17 Departments may need to respond quickly to such events, to:

- reassure the public about service continuity and achieve their own objectives (**Figure 15**); and
- safeguard their legal position, for example by establishing a channel for discussions with the administrators of a bankrupt company.

3.18 Departments may discover that circumstances have changed since they made their plans. This may include:

- increasingly vulnerable users – for example because of an economic recession or changes in their characteristics;
- increasing numbers of people using the service; and
- the service arriving at a time of maximum stress: for example, parts of the health service are particularly busy over winter, which may again affect service continuity arrangements.

3.19 The incentives operating on providers, whether in the public or private sector, may also have changed. For example:

- Local accountability mechanisms (through police and crime commissioner elections or local council elections) can set different priorities to those of national government. These may limit local bodies' capacity, capability or incentives to deliver a service in line with departmental objectives.
- If a provider has failed there may be weaker competition within the market, which may lead to falls in the quality of provision and rising costs.
- If providers are running at capacity already, then they may be less eager to take on further work. This may be a particular risk if a provider is regarded as having failed because it was unable to make money on its particular area of service delivery.
- As private companies provide more services, departments need to become more alert to the way in which the ownership and general strategy of a private provider may affect its long-term financial sustainability. In addition, they need to be aware that acquisitions may transform a market: turning it from a competitive market into a potential monopoly with increased risks from failure. Both these situations can be seen in the case explained in **Figure 16**.

Figure 15
Reacting quickly

G4S and the Olympics

In December 2011, G4S and the London Organising Committee for the Olympic and Paralympic Games (LOCOG) agreed a contract for G4S to supply 10,400 security personnel to the London Olympics, and manage a total workforce of up to 23,700. In April 2012, LOCOG commissioned a report using its audit access rights into G4S's progress. Two weeks before the games the company informed LOCOG that it would be unable to supply enough guards for the games.

Fortunately, effective contingency plans were being put in place and the armed forces and police were ready and able to step in, making a major contribution to a successful security operation, which passed off without any major problems.

Source: Comptroller and Auditor General, *The London 2012 Olympic Games and Paralympic Games: post-Games review*, Session 2012-13, HC 794, National Audit Office, December 2012

Figure 16
Adapting to the changes in circumstances

Southern Cross

The Department of Health is responsible for the adult social care market. Local authorities have statutory responsibility for adult social care and would normally step in if a provider exited the market and was not taken over or replaced by another provider to ensure continuity of service.

In 2011, Southern Cross, a care home provider, got into financial difficulties. Southern Cross had become one of the largest providers of social care in the UK, mainly through the acquisition of other providers: in some areas it was the only provider of care homes. The company sold and leased back its property portfolio thereby becoming highly leveraged. Southern Cross subsequently became unable to absorb lower income associated with lower than expected occupancy rates. Its financial difficulties intensified in early 2011. The Department did not have any existing arrangements or strategy for dealing with the potential failure of a provider of this size. It managed the situation reactively, as the financial situation facing the company unfolded and there is some evidence that Southern Cross's financial position contributed to quality failings. Southern Cross's homes were taken over by other participants in the sector. Although in the case of Southern Cross the risks to continuity of care were managed effectively, this outcome was not a foregone conclusion and was the result of considerable effort by a number of organisations and individuals, without formal processes and powers to call upon. The Department has since given responsibility for regulating the financial sustainability of care providers to the Care Quality Commission.

Source: Comptroller and Auditor General, *Oversight of user choice and provider competition in care markets*, Session 2010–2012, HC 1458, National Audit Office, September 2011

Part Four

Evaluation and feedback

4.1 This part covers:

- evaluation:
  - consider how the department's response has altered incentives in the market;
  - after a failure, it is important to reconsider the health of other providers; and
- feedback: share lessons about failure within and outside the department.

Evaluation

Consider, how the department's response has altered incentives in the market

4.2 Providers' behaviour is likely be affected by changes in incentives created by the department's response to a failure. Understanding changes in provider behaviour can help departments to redesign their own approach to the sector. Regulators in the financial sector design rescue arrangements with regard to their potential effects on 'moral hazard' (the risk that rescuing one provider creates an incentive for other providers to take risks – for which they keep the rewards – in the expectation that if they get into difficulty they will also be rescued). Such effects are also present in the public sector. Providers may presume that a department will continue to finance them should they be unable to meet an agreed specification (whether contractual or other). In the railway sector, the Department for Transport calculated that rescuing a franchisee would lead to greater costs for the public sector, as all the other private sector franchisees asked for support too (**Figure 17**).

Figure 17
Avoiding moral hazard

East Coast Mainline

In 2009, the Department for Transport decided to terminate National Express's contract for the East Coast Mainline rail franchise. In our 2011 report we concluded that the Department's decision was good value for money.

The Secretary of State for Transport has a statutory duty to ensure that passenger services continue if a franchise fails. In such circumstances, the Department may have to intervene and make arrangements to run the franchise until it can be re-let. As with other key public services, this means that the business risk when things go badly wrong cannot be transferred fully to the private sector. We found that the Department had learned from the failures of previous franchises: it had included and made use of contractual provisions to receive accurate performance information. As a result the Department became aware that National Express was in financial difficulty before the company came to them to renegotiate elements of its franchise.

The Department decided to refuse to renegotiate the franchise. It believed that had it done so, a further five franchisees could have sought to renegotiate. We concluded that termination was value for money as the Department avoided the significant risk that other franchisees would seek negotiated exits from their loss-making franchises, costing the taxpayer a minimum of £140 million.

Source: Comptroller and Auditor General, *The InterCity East Coast Passenger Rail Franchise*, Session 2010–2011, HC 824, National Audit Office, March 2011

4.3 The Office of Fair Trading, a predecessor to the Competition and Markets Authority, has been explicit: "if there is a suspicion that authorities will prop up weak firms to ensure service continuity, such firms may be tempted to continue in the market, thereby risking eventual financial or operational failure and disruptive exit".[18] It may be, after rescuing a failed provider, that if a department uses a delivery model where they expect providers to fail, then departments will need to consider how to adjust the delivery model or how to restore the credibility of their previous failure regime.

Wider work after a failure, consider the implications for the rest of the market

4.4 Once a provider has failed, the department may need to consider what the failure says about its system of service delivery. Sometimes the provider failure may reveal problems that affect all providers, and may signal that a department needs to re-evaluate its risk assessment for other providers. In others it may be a sign of a healthy market. Departments might consider in particular, the realism of their expectations of performance for providers and the costing of the provision. In our paper on Principles of Price Setting in Public Markets, we found that local authorities and departments were more successful when they set prices which sustained supply in the short and long term.[19] We have also found issues in the past when similar programmes are launched together at the same time and providers struggle to obtain enough referrals.

18 Office of Fair Trading *Orderly Exit: designing continuity regimes in public markets*, December 2012, p. 8.
19 National Audit Office, *Deciding prices in public services markets: principles for value for money*, December 2013, pp. 24, 31.

4.5 If a department considers that the service is unsustainable, it has options. These include raising the price the department pays for the service, changing the definition of the goals of the service or abandoning the programme altogether (**Figure 18** illustrates the last option). The department may consider the impact of any action upon its own priorities, the interests of users and the sustainability of a market for provision in that sector.

Feedback

Share lessons about failure within and outside the Department

4.6 Failure can be extremely expensive to the department and to users. It is therefore important that departments share what they have learned as widely as practicably possible, to avoid government paying several times to learn the same lesson. Equally, where departments successfully manage a provider failure it may be beneficial for other departments to reflect on whether there are lessons for their own contingency planning. This is particularly important for innovative projects. In our 2013 report on the Troubled Families programmes, we noted that more innovative projects require effective evaluation mechanisms during the project and after their completion so that learning is identified and not lost.[20]

4.7 Departments can also share lessons with providers, as often failures take place within the provider as well as the commissioning organisation. This may reduce the risk that government has to manage a similar provider failure in future.

Figure 18

Adjusting a project when all providers are failing

The Department for Work & Pensions, families with multiple problems programme

The Department for Work & Pensions set up its families with multiple problems programme in 2012 at around the same time as the Department for Communities and Local Government Troubled Families programme. Both of these programmes were targeted at the same group of families. Contractors on the DWP programme experienced low levels of referrals because local authorities referred families to the Troubled Families programme rather than the DWP programme.

The Department initially decided in 2013 to adapt the programme to ensure that providers would stay within it. However, while volumes of referrals rose, they did not rise far enough to make the contracts viable. The NAO reported in 2014 that some of the companies had achieved minimal outcomes. In 2014, the Permanent Secretary at DWP confirmed to the Committee of Public Accounts that he was redistributing the money from working with these families to other priorities within DWP.

The DWP programme was funded by the European Union, through the European Social Fund. Had the Department persisted with the programme, there was a risk that the Department would have had to return the European money that funded the programme and therefore not take the UK's full allocation. The Department learned from the difficulties that providers were experiencing and took a decision to re-prioritise the funding enabling the UK to still benefit from it.

Sources: Comptroller and Auditor General, *Programmes to help families facing multiple challenges*, Session 2013-14, HC 878, National Audit Office, December 2013; HC Committee of Public Accounts, *Programmes to help families facing multiple challenges*, Fifty-first Report of Session 2013-14, HC 668, April 2014

20 Comptroller and Auditor General, *Programmes to help families facing multiple challenges*, Session 2013-14, HC 878, National Audit Office, December 2013, p. 8.

Appendix One

Guidance and useful resources

Part Two: **Strategy and Planning**

HM Treasury, *The Green Book: appraisal and evaluation in central government*, November 2014.

Office for Government Commerce and National Audit Office, *Good practice contract management framework*, National Audit Office, December 2008.

National Audit Office, *Deciding prices in public services markets: principles for value for money,* December 2013.

National Audit Office and Chartered Institute of Management Accounts, *Delivering value and accountability: How finance can help,* NAO and CIMA costing paper, October 2014.

Part Three: **Measurement and Implementation**

National Audit Office and HM Treasury, *Good practice in tackling external fraud*, National Audit Office, June 2008.

National Audit Office, *Intelligent monitoring*: *An element of Financial Relationships with Third Sector Organisations*, June 2009.

Part Four: **Evaluation and Feedback**

Cabinet Office and HM Treasury, *The Magenta Book*: Guidance for evaluation, April 2011.

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National Audit Office

£10.00

ISBN 978-1-904219-89-7

Design and Production by NAO Communications
DP Ref: 10760-001