



National Audit Office

Report

by the Comptroller
and Auditor General

Ministry of Justice, HM Prison & Probation Service

Investigation into changes to Community Rehabilitation Company contracts

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National Audit Office

Ministry of Justice, HM Prison & Probation Service

Investigation into changes to Community Rehabilitation Company contracts

Report by the Comptroller and Auditor General

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National Audit Act 1983 for presentation to the House of
Commons in accordance with Section 9 of the Act

Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

15 December 2017

This investigation sets out the facts in relation to recent changes to Community Rehabilitation Company contracts.

Investigations

We conduct investigations to establish the underlying facts in circumstances where concerns have been raised with us, or in response to intelligence that we have gathered through our wider work.

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Key facts

£64m + £278m = £342m

additional fee for service paid by the Ministry of Justice (the Ministry) to CRCs in 2016-17 (£42 million) and 2017-18 (£22 million)

additional projected payments by the Ministry to CRCs after changes to the contracts taking effect from 1 August 2017

additional fee for service that the Ministry would pay CRCs from August 2017 (up to 2021-22) after its additional fee for service payments in 2017-18 and its adjustments to the payment mechanism

21	number of Community Rehabilitation Companies (CRCs) in England and Wales
£3.7 billion	maximum projected fee for service that the Ministry would pay CRCs when the contracts became operational
£2.5 billion	maximum projected fee for service the Ministry would pay CRCs from August 2017-18 (up to 2021-22) after its additional fee for service payments in 2017-18 and after its changes to the contracts
£443 million	total forecast losses expected by CRCs in March 2017, from 2016-17 to 2021-22
77%	the Ministry's revised assumption in the contracts of the proportion of fixed costs in CRCs – the original assumption was 20%
£567 million	the Ministry's maximum projected payments to CRCs under payment by results over the life of the contracts

What this investigation is about

1 Probation services are overseen by HM Prison & Probation Service (HMPPS), an executive agency of the Ministry of Justice (the Ministry). The purposes of probation services are to:

- protect the public;
- reduce reoffending and rehabilitate offenders;
- carry out the proper punishment of offenders; and
- ensure offenders are aware of the impact of crime on victims and the public.¹

2 In June 2014 the Ministry introduced its Transforming Rehabilitation reforms. It dissolved 35 self-governing probation trusts and created a public sector National Probation Service and 21 Community Rehabilitation Companies (CRCs). CRCs supervise offenders who present a low or medium risk of harm, while the National Probation Service manages offenders who present higher risks. In February 2015, following an extensive procurement, the CRCs were transferred to eight, mainly private sector, suppliers working under contracts managed by the National Offender Management Service (now HMPPS). The contracts run to January 2022.

3 The purpose of the Ministry's reforms was to:

- open up the market to a diverse range of rehabilitation suppliers from the private and voluntary sectors;
- incentivise innovation, paying suppliers by results for reducing reoffending; and
- extend statutory rehabilitation to those serving sentences of less than 12 months.²

4 We last reported on the reforms in April 2016.³ We found that CRCs' activity volumes were lower than the Ministry expected during the procurement, which, if translated into reduced income, would affect the ability of CRCs to transform their businesses. We also identified that income shortfalls would affect CRCs' capacity to introduce new ways of rehabilitating offenders. We recommended that the Ministry should regularly review how it paid for services, to ensure that it incorporated and incentivised innovative approaches to reducing reoffending. We also recommended that the National Offender Management Service (now HMPPS) needed a deeper understanding of the financial and service viability of CRCs.

1 Comptroller and Auditor General, *Transforming Rehabilitation*, Session 2015-16, HC 951, National Audit Office, April 2016.

2 See footnote 1.

3 See footnote 1.

5 The Committee of Public Accounts' subsequent report found that the negotiations to resolve the issue of CRCs' reduced activity volumes were undermining the objectives of the reforms.⁴ It recommended that the Ministry should review and adapt the way CRCs are paid for their work to create stronger incentives for them to provide innovative services that meet the needs of all groups and reduce reoffending. The Committee asked the Ministry to keep it updated on negotiations to resolve the difficulties associated with lower activity volumes.

6 In February 2016, the Ministry launched a probation system review. Its purpose was to identify and implement changes that would help to achieve the reforms' aims. The review addressed several areas, but focused primarily on the payment mechanism within the contracts.

7 In 2017, the Ministry took action to ensure continuity of probation services in England and Wales by amending its contracts with CRCs to improve their financial stability. In May 2017, it published its intent to modify the contracts in the Official Journal of the European Union. These changes would alter the payments the Ministry would make to CRCs from 2017-18.

8 The Secretary of State for Justice announced in July 2017 that the probation system had "encountered unforeseen challenges" and that the Ministry had "adjusted the CRCs' contracts to reflect more accurately the cost of providing critical frontline services".⁵ The contract changes took effect from 1 August 2017 for most CRCs.

9 In August 2017, we received correspondence expressing concerns about the transparency of the contract changes in the context of CRCs' performance. We have produced this report to set out the facts in relation to:

- why the Ministry adjusted CRCs' contracts (Part One);
- how the Ministry adjusted the contracts (Part Two); and
- the financial and other implications of the adjustments to the CRCs' contracts (Part Three).

10 We did not examine the value for money implications of the contract changes.

⁴ Committee of Public Accounts, Transforming Rehabilitation, Seventeenth report of Session 2016-17, HC 484, September 2016.

⁵ Ministry of Justice, Probation reform: open letter from the Secretary of State for Justice, 19 July 2017.

Summary

Key findings

Why the Ministry of Justice (the Ministry) adjusted Community Rehabilitation Companies' (CRCs) contracts

1 The volumes of activity CRCs are paid for are well below the levels expected when the contracts were let, while the number of offenders supervised has increased. The CRC contracts specify different payment bands for providing different types of rehabilitation services. CRCs are paid on the basis of weighted volumes that reflect these differences. In 2015-16, the actual weighted volumes of activity undertaken by CRCs ranged from 8% to 34% less than originally anticipated. This pattern has continued in the first quarter of 2017-18, with volumes of activity from 16% to 48% less than originally anticipated. The Ministry believes that this is explained by differences in the types of criminal cases heard by the courts and changes in the requirements attached to offenders' sentences. At the same time between the first quarters of 2015-16 and 2017-18, the number of offenders supervised by CRCs increased by 20% (paragraphs 1.3, 1.5 and Figure 3).

2 The Ministry projected that the maximum it would pay CRCs for rehabilitation services over the duration of the contracts had decreased from £3.7 billion to £2.1 billion. Most CRCs' income is paid for their activities supervising offenders, based on the weighted volumes of work that they do, termed 'fee for service'. When we reported on the Transforming Rehabilitation reforms in 2016, the Ministry projected the maximum fee for service it would pay CRCs over the life of the contracts would be £3.7 billion. The reduced volumes of activity CRCs are paid for led the Ministry to project in 2016-17 that, if the terms of the contracts were applied, the maximum fee for service it would pay CRCs would be £2.1 billion (paragraphs 1.3 and 1.4).

3 By the end of 2016-17, the Ministry had paid £956 million to CRCs in fees for service, £42 million more than it would have done had it applied the terms of the contract. The lower weighted volumes of activity meant that contractually the Ministry could have paid CRCs less. Under the terms of the contract, the Ministry would have paid CRCs £351 million in fees for service for 2016-17. CRCs told the Ministry, however, that they could not maintain existing levels of service if they were paid at lower rates. In response, the Ministry paid CRCs £393 million for their work in 2016-17 (paragraphs 1.6 and 1.7).

4 In July 2016, the Ministry concluded that adjusting the payment mechanism in the CRC contracts should be an immediate priority. The Ministry undertook further work with CRCs to understand the impact of lower than expected weighted volumes of activity, and to explore the options to address the issue. It concluded that CRCs' falling income was contributing to the delivery of poor quality basic services in the contracts (paragraph 1.16).

5 By the end of June 2017, CRCs had met one-third of the performance targets set by the Ministry. The Ministry expected CRCs to be meeting 24 targets from the end of February 2017. By the end of June 2017, CRCs had met eight (33%). By this point, the Ministry had raised service credits with an overall value of £7.7 million, and it had applied £2 million of these in deductions from its payments to CRCs. The remaining service credits were reinvested by CRCs back into services, waived or are subject to ongoing negotiations. HM Inspectorate of Probation and HM Inspectorate of Prisons have also raised concerns about the financial stability of CRCs and the quality of rehabilitation services (paragraphs 1.8 to 1.12 and Figure 4).

How the Ministry of Justice adjusted Community Rehabilitation Companies' contracts

6 Between October and December 2016, the Ministry sought to stabilise the CRC contracts and improve operational performance. The Ministry developed a range of options to change the contracts. It considered their likely impact on the performance and continuity of the contracts, value for money and other factors such as having to instigate a new procurement, affordability and the risk of legal challenge. It chose to adjust the payment mechanism to allow it to alter the way in which its fee for service payments to CRCs changed in relation to CRCs' costs. The Ministry had sought to transfer volume risk to CRCs through the contracts, and secured parent company guarantees to provide financial protection to the taxpayer should CRCs seriously underperform, fail outright or become insolvent. It chose to change the contract to maintain the continuity of probation services on the grounds that the scale of drop in activity volumes was unforeseen by both the Ministry and CRCs (paragraphs 2.1 to 2.3).

7 Throughout February 2017, the Ministry commissioned external assurance work to better understand the financial positions of the CRCs. CRCs were asked to submit financial returns based on written guidance provided by the Ministry, which challenged the returns. The returns reported:

- total projected losses of £443 million from 2016-17 to 2021-22 across all CRCs if the contracts continued without any changes (paragraph 2.5);
- fixed costs were higher than CRCs had anticipated during the procurement – CRCs reported that, on average, 77% of their costs were fixed, compared with the Ministry's original assumptions of 20% agreed in the contracts (paragraph 2.6); and
- the percentage of fixed costs varied between CRCs from 44% to 99.8% (paragraphs 2.5, 2.6 and Figure 5).

8 The Ministry concluded that it and bidders had overestimated CRCs' ability to reduce their costs, and amended the contracts to recognise this. The CRC contracts define how fees paid to CRCs change in line with weighted volumes of activity through the marginal adjustment factor (MAF). The Ministry amended the MAF to take account of the higher than expected fixed costs reported by the CRCs. It made this decision so that, if CRCs' activity volumes fell further, the amount the Ministry paid to CRCs would fall at a slower rate. The Ministry applied the same assumption that 77% of costs were fixed to all CRC contracts (paragraphs 2.7, 3.2 and Figure 6).

The financial and other impacts of the changes to Community Rehabilitation Companies' contracts

9 While it was negotiating the contract change, the Ministry paid 14 CRCs additional fees of £22 million. Before it implemented changes to the contracts, the Ministry paid 14 CRCs increased fee for service payments of £22 million for the period 1 April 2017 to 31 July 2017. The Ministry did this because its 2016-17 agreements (paragraph 3) would have expired before it could agree on and implement the contract adjustments. These payments reflected a weighted volume of activity that was higher than the CRCs' actual positions (paragraph 3.1).

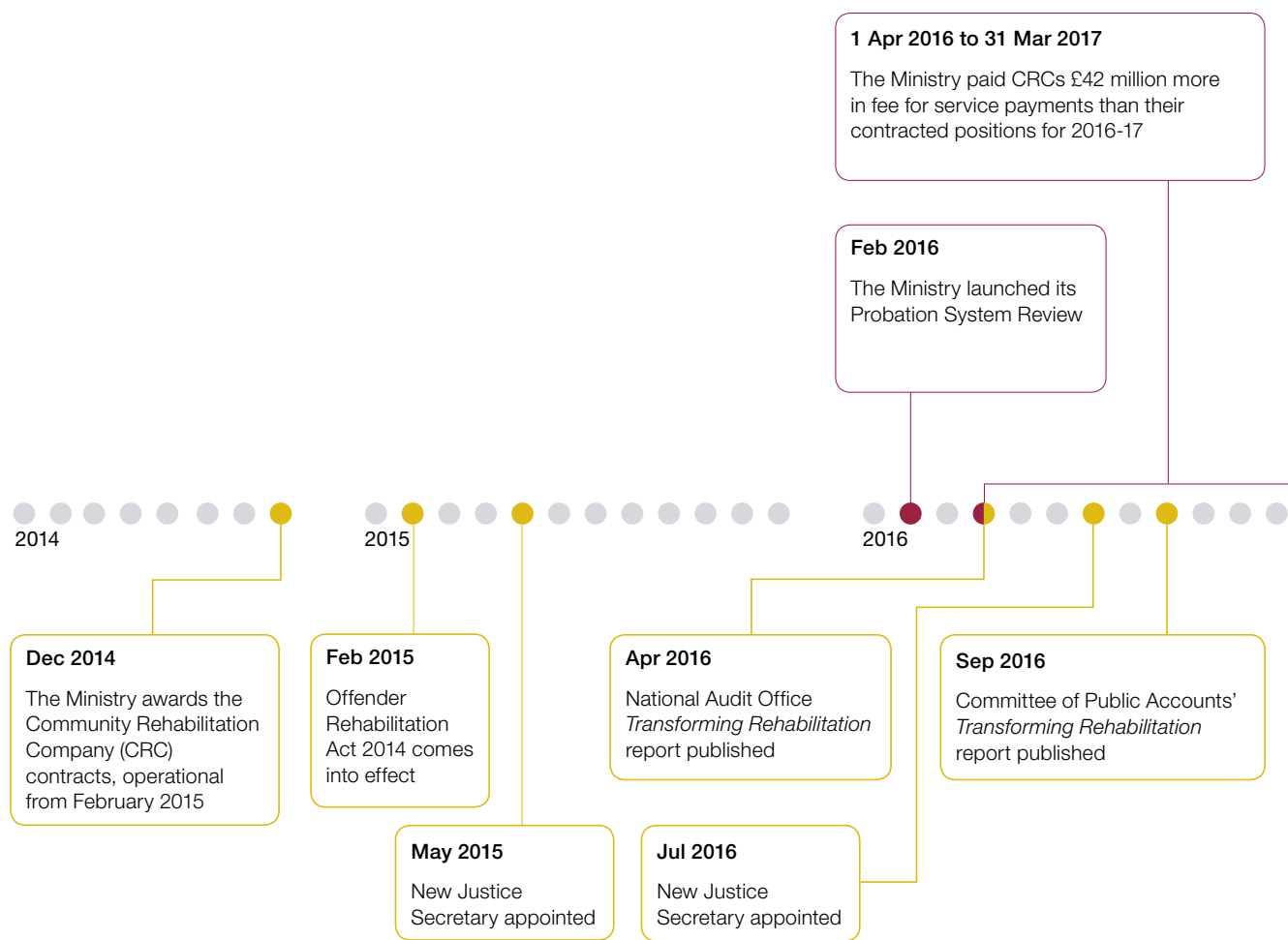
10 Following the contract adjustments, the Ministry's maximum projected payments to CRCs for rehabilitation services increased by £278 million. The Ministry signed variations to the contracts on 6 June 2017, which became effective for most CRCs from 1 August 2017. The changes increased the Ministry's maximum projected payment to CRCs for fee for service over the life of the contracts by £278 million. Combining this with the additional payments of £42 million and £22 million gives total additional projected payments of £342 million. The Ministry estimates the maximum fee for service payments will increase to £2.5 billion. This is below the £3.7 billion projected in 2016 but covers much lower volumes of activity than projected at that time. The increased maximum projected payments to CRCs are below the Ministry's estimates when the contracts were awarded (paragraph 3.3).

11 The impact of the contract change affects different CRCs to different degrees. The Ministry applied its change to the MAF equally to all CRCs, but its impact will depend on the financial position of individual CRCs:

- The Ministry's maximum projected payments to CRCs arising from the adjustments range between £6 million and £37 million (paragraph 3.4).
- The increase in the Ministry's projected payments to CRCs does not cover forecast losses for the majority of CRCs. Increases in maximum projected payments are higher than forecast losses for seven CRCs, and lower than forecast losses for 14 CRCs (paragraph 3.5 and Figure 7).

12 As the contracts progress the level of income CRCs receive will increasingly depend on their success at reducing reoffending. The Ministry included payment by results arrangements to incentivise innovative approaches to reducing reoffending. The maximum projected payments to CRCs through payment by results is £567 million. This represents 18% of total projected payments over the life of the contracts, but this proportion increases from 6% in 2015-16 to 28% in 2020-21. Initial reoffending data for England and Wales since the Transforming Rehabilitation reforms show a 2.2% reduction from the rate in January to March 2011. However, the frequency of reoffences per reoffender appears to be increasing. Initial results show that 13 of the 21 CRCs have made statistically significant reductions in the reoffending rate in the first quarterly cohort, when compared to 2011 baseline reoffending rates. The first performance payments to CRCs informed by reoffending data are due in January 2018, when the data on frequency of reoffending are published (paragraphs 3.6 to 3.8 and Figures 8 and 9).

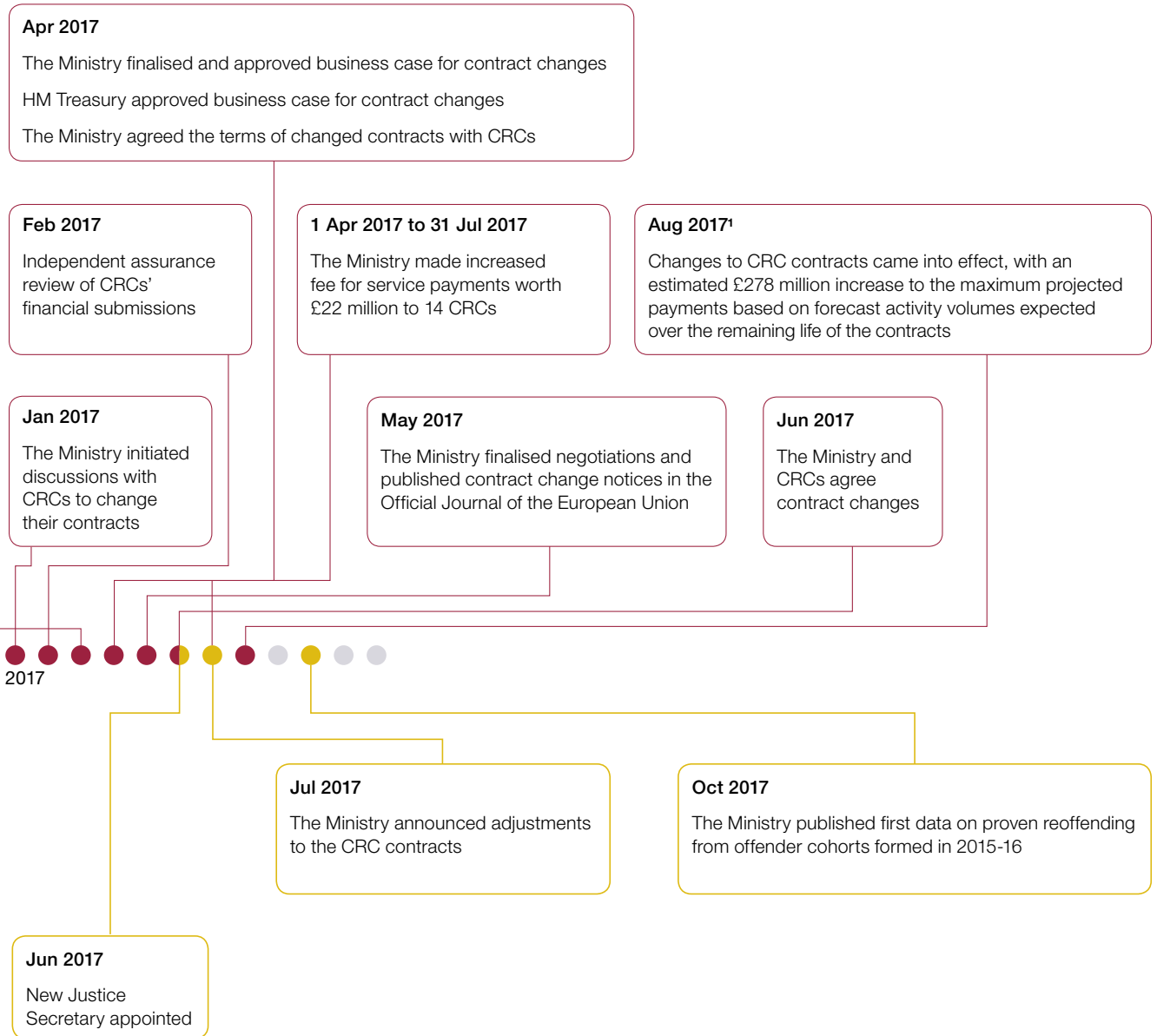
Figure 1
Timeline of events for changes to Community Rehabilitation Company contracts



- Contract change events
- Wider events

Note
1 Changes to CRC contracts for six CRCs owned by Sodexo became effective on 1 July 2017.

Source: National Audit Office analysis of Ministry of Justice documents



Part One

Why the Ministry of Justice adjusted Community Rehabilitation Companies' contracts

Community Rehabilitation Companies

1.1 In June 2014, the Ministry of Justice (the Ministry) reformed probation services by dissolving 35 self-governing probation trusts and forming a public sector National Probation Service and 21 Community Rehabilitation Companies (CRCs). The Ministry let contracts from February 2015 for the CRCs to provide rehabilitation services for offenders who present a low or medium risk of harm. The 21 CRCs are run by eight, primarily private sector, parent organisations (**Figure 2** on page 16).

Payments made to CRCs

1.2 The contracts with the CRCs set out three main types of payment:

- a **'fee for service'**, for the satisfactory completion of activities with offenders; worth around £2.5 billion over the life of the contracts according to the Ministry's most recent projections in July 2017 (82%);
- **'payment by results'**, triggered by proven reductions in reoffending after two years, with a maximum value of £567 million over the life of the contracts under recent projections (18%); and
- a **'fee for use'** to cover work done for other parties, for example if the National Probation Service commissions CRCs to provide services for high-risk offenders.⁶

⁶ The 21 CRCs estimate that they will receive £77 million in fee for use income between 2016-17 and 2021-22 for providing services to the National Probation Service.

Fee for service

1.3 The CRC contracts specify different payment bands for providing different types of rehabilitation services. CRCs are paid on the basis of weighted volumes that reflect these differences. The Ministry pays CRCs fee for service payments according to the volumes of activity it predicts they will carry out.⁷ CRCs are paid for activities they undertake rather than for the volumes of offenders they supervise. These activities are specified as 'offender supervision requirements', such as the completion of community sentences and suspended sentence orders set by the courts. Before it awarded the contracts, the Ministry used historical data to estimate the volumes of offenders that CRCs would supervise and the volumes of activities they would undertake.

1.4 In the first two years of the contract, the Ministry paid all CRCs' fees within the same payment band. From 2016-17, the Ministry could adjust the payment bands for CRCs to align with the actual volumes of activity being undertaken. When we reported on the Transforming Rehabilitation reforms in April 2016, the Ministry projected that the maximum fee for service it would pay CRCs over the life of the contracts would be £3.7 billion.⁸ Since 2014-15, the volume of activity which CRCs are paid for under the contracts has reduced. If the terms of the contracts were applied as originally intended, the Ministry estimates that the maximum fee for service it would pay CRCs would be £2.1 billion. These figures are based on the Ministry's forecast volumes of activity over the remaining life of the contracts and would change if volumes of activity change.

CRCs' predicted and actual volumes of activity

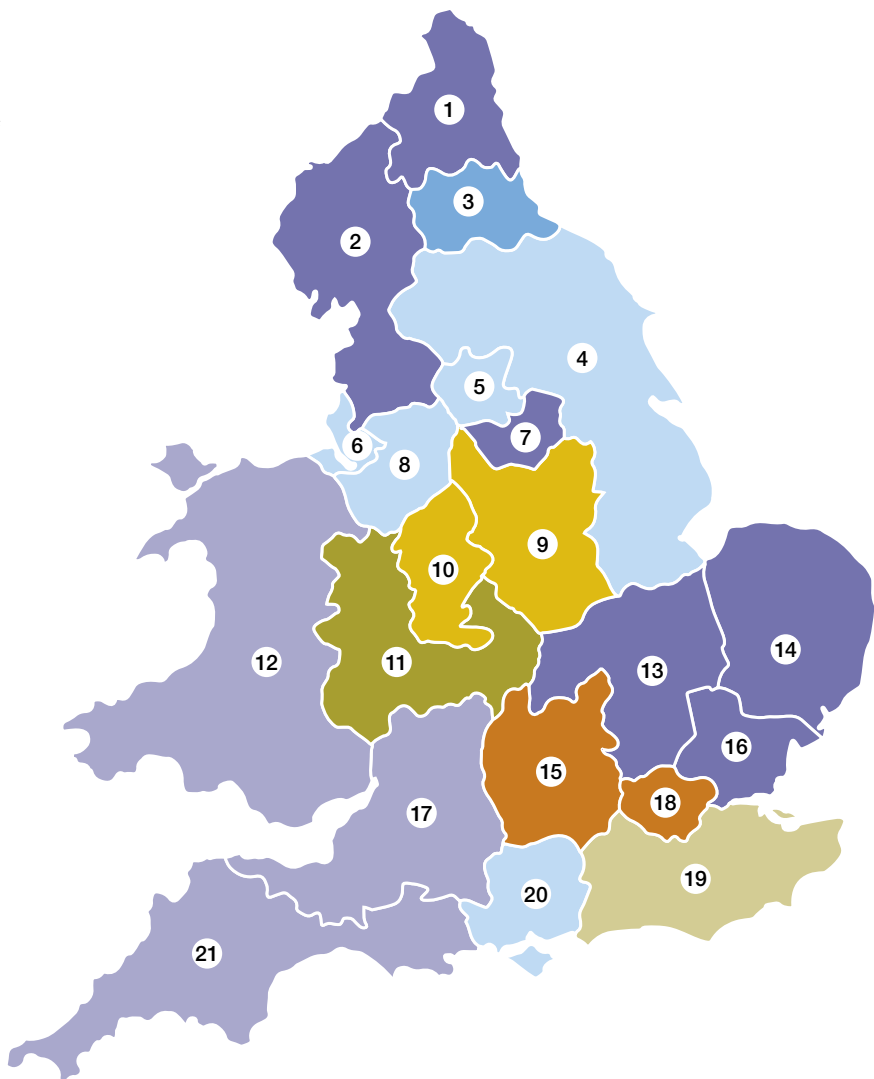
1.5 In 2015-16, the actual volumes of activity by CRCs under the contracts ranged from between 8% and 34% less than that originally anticipated when the contracts were let, the contractual baseline. Annualised data from the first quarter of 2017-18 show an indicative position of activity volumes between 16% and 48% less than originally anticipated for 2017-18 (**Figure 3** on pages 17 and 18). The Ministry believes that this is explained by differences in the types of criminal cases heard by the courts and changes in the requirements attached to offenders' sentences. For example, in 2006, accredited programmes to help offenders with problems such as domestic violence, accounted for 17% of community orders and suspended sentence orders set by the courts. In 2016, the proportion was 7%. Between the first quarters of 2015-16 and 2017-18, the number of offenders supervised by CRCs increased by 20%. The Ministry has identified that CRCs' increasing caseloads are explained by its decision to extend statutory supervision to offenders serving sentences of 12 months or less.

⁷ The Ministry carries out data reconciliations to calculate the difference between the CRCs' predicted volumes of activity and their actual volumes of activity.

⁸ Comptroller and Auditor General, *Transforming Rehabilitation*, Session 2015-16, HC 951, National Audit Office, April 2016.

Figure 2
Community Rehabilitation Companies and parent organisations in England and Wales

- Sodexo with Nacro
- Working Links (company) with probation staff mutual
- ARCC consortia with probation staff
- Purple Futures, an Interserve-led partnership
- MTCnovo – MTC, Amey and others
- Reducing Reoffending Partnership – Ingeus UK and St. Giles Trust
- PeoplePlus
- Seetec



- | | | |
|---|---|---|
| 1 Northumbria | 12 Wales | 17 Bristol, Gloucestershire, Somerset and Wiltshire |
| 2 Cumbria and Lancashire | 13 Bedfordshire, Northamptonshire, Cambridgeshire and Hertfordshire | 18 London |
| 3 Durham Tees Valley | 14 Norfolk and Suffolk | 19 Kent, Surrey and Sussex |
| 4 Humberside, Lincolnshire and North Yorkshire | 15 Thames Valley | 20 Hampshire and Isle of Wight |
| 5 West Yorkshire | 16 Essex | 21 Dorset, Devon and Cornwall |
| 6 Merseyside | | |
| 7 South Yorkshire | | |
| 8 Cheshire and Greater Manchester | | |
| 9 Derbyshire, Leicestershire, Nottinghamshire and Rutland | | |
| 10 Staffordshire and West Midlands | | |
| 11 Warwickshire and West Mercia | | |

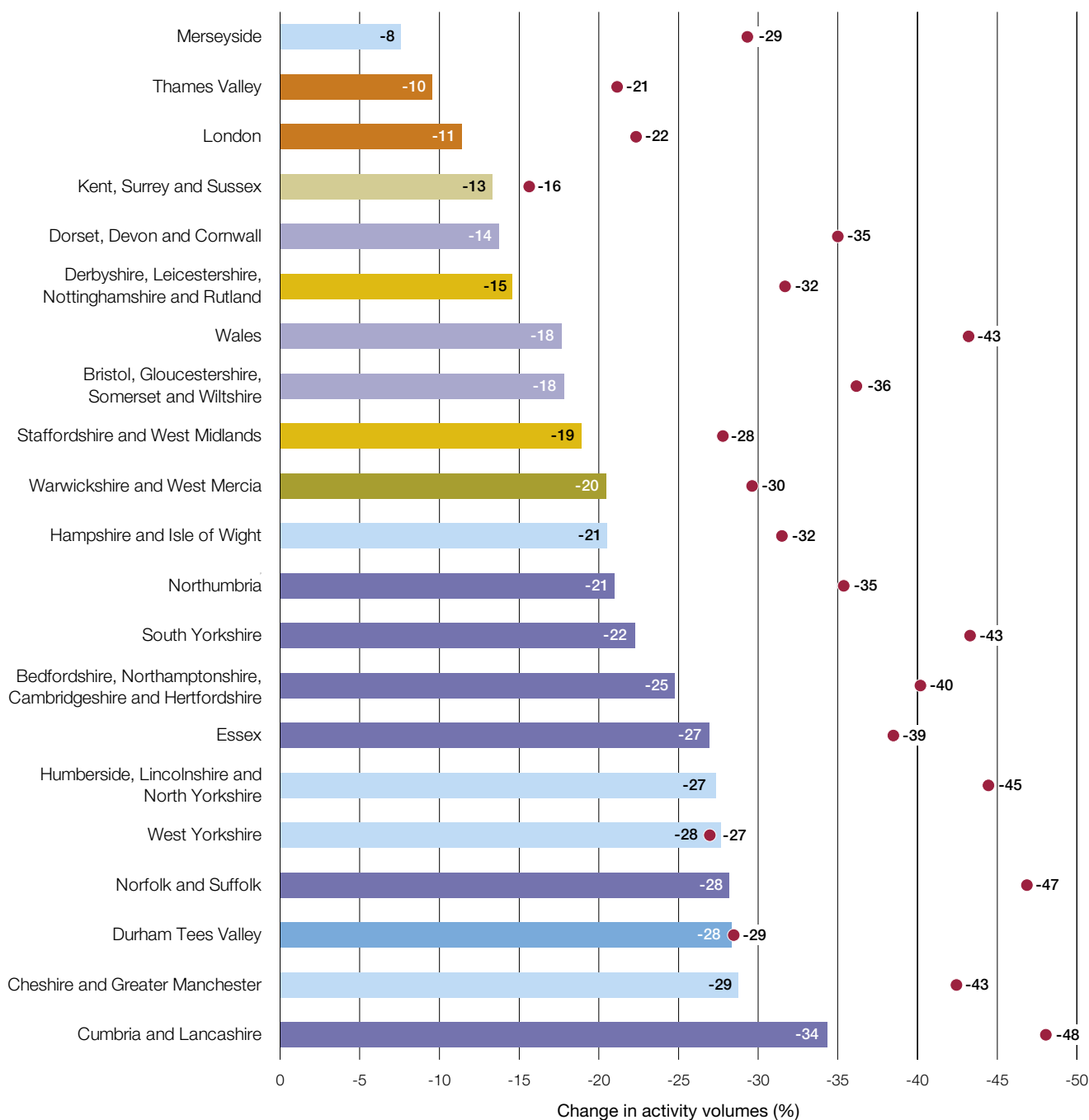
Source: National Audit Office analysis of Ministry of Justice documents

Figure 3

Reductions in Community Rehabilitation Companies' activity volumes between 2015-16 and 2017-18, compared with initial assumptions

Activity volumes in CRCs have been lower than expected when the contracts were awarded

Community Rehabilitation Companies



● 2017-18

continued overleaf

Figure 3 *continued*

Reductions in Community Rehabilitation Companies' activity volumes between 2015-16 and 2017-18, compared with initial assumptions

Notes

- 1 Data for 2015-16 are represented in coloured bars, and actual reconciled data prepared by the Ministry of Justice.
- 2 Data for 2017-18 are represented by dots, and are annualised using reconciled data for quarter one.
- 3 The Ministry pays CRCs according to the volumes of activity it predicts they will carry out. These activities are specified as 'offender supervision requirements', such as the completion of community sentences and suspended sentence orders set by the courts.

Source: National Audit Office analysis of Ministry of Justice data

Commercial viability of the contracts

1.6 The Ministry paid CRCs £562 million in fees for service for 2014-15 and 2015-16. If the terms of the contracts had been applied, then the Ministry would have paid CRCs £351 million in 2016-17 due to lower predicted volumes of activity. Suppliers indicated that the projected reduction in volumes of activity placed the long-term commercial viability of the contracts in doubt. CRCs made representations to the Ministry about the level of revenue necessary for them to provide their contracted services and to proceed with their service transformation plans. They also told the Ministry that they could not maintain existing levels of service if they were paid at the lower rates.

1.7 In response, the Ministry paid CRCs around £393 million, £42 million more than the contracts required. The Ministry exercised its discretion to pay CRCs at higher payment rates because it had by then begun commercial negotiations to agree long-term changes to the contracts. Following a reconciliation of projected and actual activity volumes for 2016-17, the Ministry has identified that it is due £9 million from CRCs under the terms of the contract. The Ministry has not decided whether it will collect all or part of the £9 million, due to 'wider commercial considerations'.

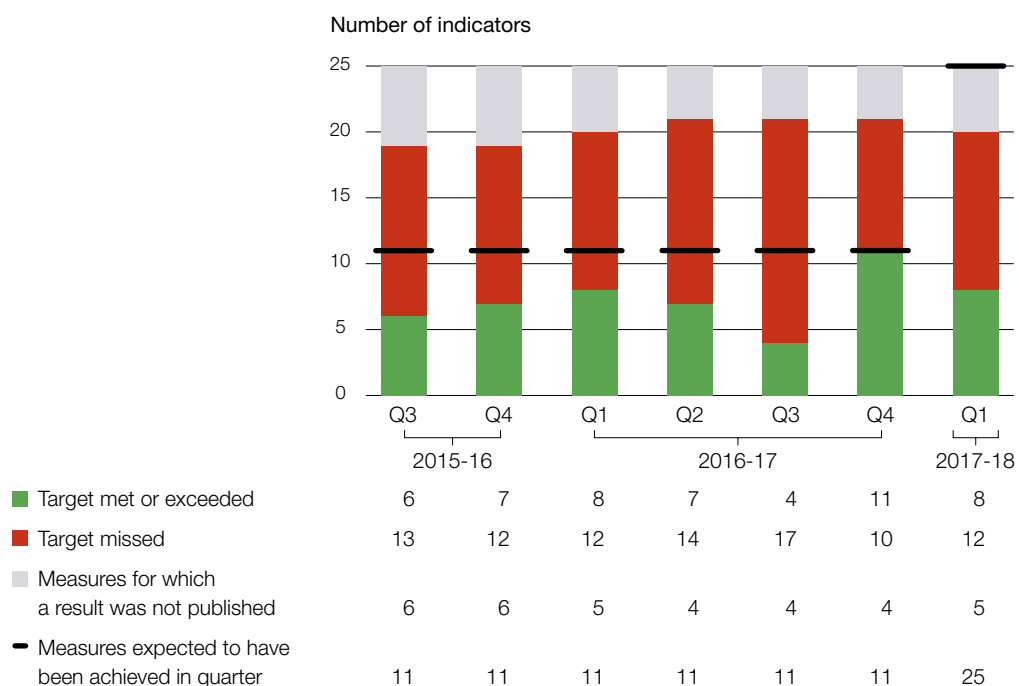
CRCs' performance

1.8 The CRC contracts specify 17 service levels and seven assurance metrics for reporting performance in offender management from the start of the sentence, through resettlement into the community, to completion of the sentence. This creates 24 targets, one of which is reported on in two parts, making 25 indicators in total. The Ministry publishes quarterly data on CRCs' performance against these indicators. CRCs are expected to meet 'end-state targets' (**Figure 4**).

Figure 4

Community Rehabilitation Companies' performance against targets for service level indicators since 2015-16, by quarter

The CRC contracts specify performance targets set by the Ministry for reporting performance in offender management

**Notes**

- 1 There are 24 performance targets. One target is reported on in two parts, making 25 indicators in total.
- 2 Data may not be published for every quarter. In quarters for which data were not published, the result from the prior release is included.
- 3 Data may not cover all CRCs for every quarter, for example, if the Ministry is investigating the quality of CRCs' reported data, or if it considers coverage is insufficiently robust. These data are recorded in the category 'measures for which a result was not published'.
- 4 The Ministry expected all targets to be met from the end of February 2017. The first full quarter where all targets were expected to be met was quarter one 2017-18.

Source: National Audit Office analysis of Ministry of Justice data

1.9 The Ministry expected CRCs to be meeting 11 of the indicators from the start of the contracts. It expected them to be meeting the remaining 14 from the end of February 2017. The most heavily weighted service level indicator – the completion of community orders and suspended sentence orders – was, on average, achieved by CRCs in each quarter between October to December 2015 and April to June 2017.

1.10 We previously reported that, by December 2015, CRCs were meeting targets for seven of the 19 measures for which the Ministry considered robust data were available. By the end of June 2017, CRCs on average had met eight of the 24 targets (33%) nationally, with performance across CRCs varying from between four and 16 targets being met. Of those that were not met, nine were considered by the Ministry to be sufficiently closer to target levels to not require CRCs' to improve their performance through an action plan. In June 2017, HM Inspectorate of Probation and HM Inspectorate of Prisons reported that CRCs are struggling financially and most have “invested little” in services beyond minimum contractual expectations.^{9,10} HM Chief Inspector of Probation has raised concerns that the system is not working as expected, and that CRCs are not generally producing good-quality work.¹¹

1.11 Figure 4 shows the completeness of performance information and the achievement against targets since we reported in April 2016. Performance against one measure that lacked available data at that time has since become available. Four measures remain without any published data due to lack of robust information.

1.12 If a CRC fails to meet service levels, the Ministry may deduct ‘service credits’ from its fee for service payments to CRCs. Between July to September 2015 and April to June 2017, the Ministry had raised service credits with an overall value of £7.7 million. Of these, the Ministry:

- allowed CRCs to reinvest £3.3 million back into services (42%);
- waived £2.2 million (29%);
- applied £2 million (27%); and
- is negotiating with CRCs for service credits worth £102,000 (1%).

1.13 The Ministry told us that it had waived service credits where it had agreed with CRCs that factors beyond their control have led to under-performance or where updated data show that service credits should not have been raised. It told us that the value of service credits raised are reinvested by CRCs in services where they have made a business case to the Ministry to do so.

⁹ Justice Committee, *Transforming Rehabilitation*, 21 March 2017, HC 1018.

¹⁰ HM Inspectorate of Probation and HM Inspectorate of Prisons, *An Inspection of Through the Gate Resettlement Services for Prisoners Serving 12 Months or More*, June 2017.

¹¹ HM Chief Inspector of Probation, Keynote speech to the Criminal Justice Management Conference 2017, 19 September 2017.

The Ministry's response

1.14 The Ministry established a probation system review in February 2016, which concluded that the contract payment mechanism needed addressing so that:

- CRCs were given incentives to innovate and invest in activities likely to reduce reoffending;
- CRCs received enough revenue over the life of the contracts to provide a commercially viable service;
- CRCs engaged better with voluntary service organisations; and
- any changes were affordable to the Ministry.

1.15 The Ministry's review, which included feedback from suppliers, concluded that:

- the payment model was too complex and failed to recognise CRCs' increasing caseloads (in contrast to volumes of activity that attract a payment);
- the payment mechanism did not reflect the administrative burden of managing caseloads; and
- the amount of time allowed in the contracts for CRCs to reduce their costs before the payment mechanism caused a drop in income did not reflect the actual time it took for a CRC to adjust its cost base and operations.

1.16 In July 2016, the Ministry concluded that adjusting the payment mechanism in the CRC contracts should be an immediate priority. It determined that further work should be undertaken with suppliers to understand the financial impact of issues with the contracts and explore options available to address the problems. It concluded that the falling income of CRCs was contributing to the delivery of "poor quality basic services in the contracts, including supporting offenders in their transition from custody to the community".

1.17 We address how the Ministry adjusted the CRC contracts in Part Two.

Part Two

How the Ministry of Justice adjusted the contracts

Developing options and understanding the changes needed

2.1 Between October and December 2016, the Ministry of Justice (the Ministry) developed a range of options to change the contracts and to ensure sustainable and improved operational performance for the remaining years of the contracts to 2021-22. The options covered three main categories:

- applying the terms of the original contracts (do nothing);
- making various adjustments to the payment mechanism; and
- terminating some or all of the Community Rehabilitation Company (CRC) contracts, which might require re-procurement, or allowing the market to consolidate, resulting in fewer suppliers.

2.2 The Ministry considered the likely effect of its options in terms of performance and continuity of services, value for money, and other factors such as having to instigate a new procurement, affordability and the risk of legal challenge. It decided to develop plans to adjust the payment mechanism by altering the way its fee for service payments to CRCs changed in relation to CRCs' costs when it reduced or increased CRCs' payment bands (see paragraphs 1.3 and 1.4).

2.3 The Ministry had sought to transfer volume risk to CRCs through the contracts, and secured parent company guarantees to provide financial protection to the taxpayer should CRCs seriously underperform, fail outright or become insolvent. It chose to change the contracts to maintain the continuity of probation services on the grounds that the scale of drop in activity volumes was unforeseen by both the Ministry and CRCs. We previously reported that in its business case for the reforms, the Ministry modelled the effect of a 2% annual reduction in activity volumes; actual reductions were far greater than this (Figure 3).

2.4 The Ministry's preferred option required it to adjust part of the payment mechanism called the marginal adjustment factor (MAF). The MAF is intended to reflect CRCs' estimated marginal cost of providing services. It uses assumptions about the distribution of CRCs' fixed, semi-variable and variable costs. When the Ministry awarded its contracts, it assumed a distribution of 20%, 70% and 10% respectively of fixed, semi-variable and variable costs.¹² The Ministry's assumptions about fixed costs in the MAF determine the rate at which its fee for service payments decrease when CRCs' volumes of activity are lower than expected.

2.5 Throughout February 2017, the Ministry commissioned external assurance work to understand the CRCs' financial positions between 2016-17 and 2021-22. CRCs were asked to submit financial returns based on written guidance provided by the Ministry, which challenged the returns. This included estimates of projected income, expenses, net profit and other income. As part of this assurance work, CRCs reported total projected losses of £443 million from 2016-17 to 2021-22, if the contracts continued as planned without any changes.

2.6 Analysis of CRCs' financial submissions identified that their average reported fixed costs were 77% of their overall cost. This was higher than the 20% agreed in the contracts. The percentage of costs reported as fixed varied between CRCs, from 44% to 99.8% (**Figure 5** overleaf).

The revised payment mechanism

2.7 The Ministry's preferred option was to adjust the MAF in the contracts for all CRCs, as it recognised that it and bidders had overestimated CRCs' ability to reduce their costs in response to lower volumes of activity. It therefore decided to adjust the MAF using the reported 77% average fixed costs. The Ministry considered this to be the most pragmatic option to stabilise CRCs' finances and to enable them to plan.

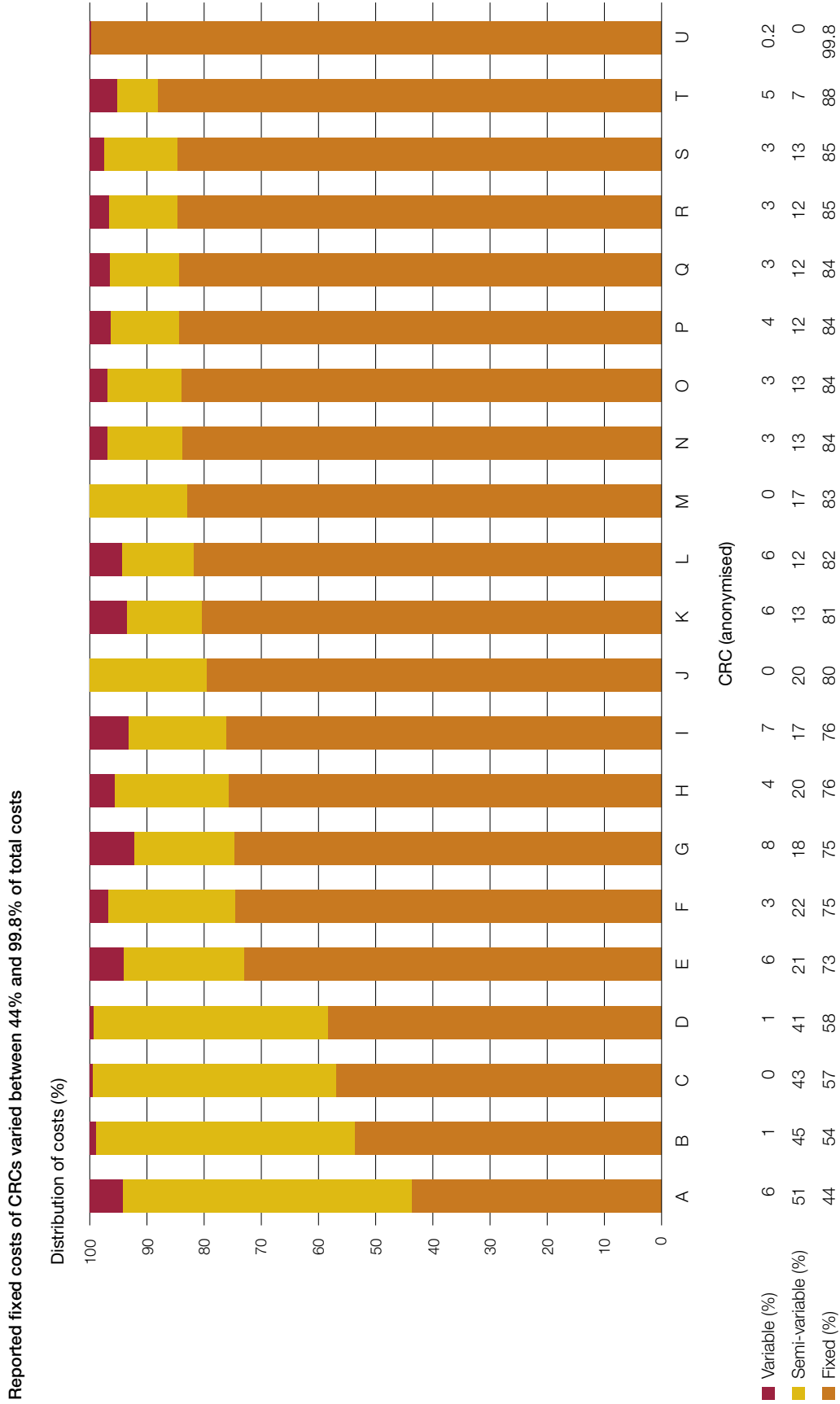
2.8 The completion of the contract variation was conditional on the CRCs agreeing to an excess profit mechanism. The revised contracts contain a clause which means that 100% of CRCs' profits above a 25% margin in a financial year must be invested in additional rehabilitation services.

2.9 On 21 April 2017, HM Treasury approved the Ministry's business case to agree changes to the payment mechanism in the CRC contracts. It applied conditions relating to HM Treasury being updated regularly on the impact of the additional funding and the quality of services, a requirement for HM Treasury's approval for any further contract changes, and that the Ministry would pay the increased costs caused by the change from its existing budget.

2.10 At the same time, the Cabinet Office required that the contract management arrangements for CRCs were reviewed by its Commercial Continuous Improvement team within six months of the changes to the contracts.

¹² In the contracts, fixed costs are those that can be changed only after one year or more. Semi-variable costs are those that can be changed within three months to one year. Variable costs are those that can be changed within three months.

Figure 5
Reported distribution of fixed, semi-variable and variable costs between 2017-18 and 2021-22, by Community Rehabilitation Company



Note

1 Due to rounding some figures do not sum to 100%.

Source: National Audit Office analysis of Community Rehabilitation Companies financial returns

Part Three

The financial and other implications of the adjustment to the contracts

Additional fee for service payments in 2017-18

3.1 The Ministry of Justice (the Ministry) made higher fee for service payments to 14 Community Rehabilitation Companies (CRCs), paying them £22 million for the period 1 April 2017 to 31 July 2017. It did this because its 2016-17 agreements would have expired before it could agree on and implement the change to the marginal adjustment factor (MAF). Its payments reflected a weighted volume of activity that was higher than the CRCs' actual positions. Payments to the 14 CRCs ranged from £600,000 to £5.2 million.

MAF adjustment

3.2 The effect of the 20% fixed costs assumption under the original contracts meant that, as CRCs' volumes of activity fell, the Ministry's fee for service payments to the CRCs fell at a higher rate as payment bands were reduced. Under the varied contracts, the fixed costs assumption of 77% means that the Ministry's payments to CRCs fall at a slower rate as payment bands are reduced (see paragraphs 1.3 and 1.4). Conversely, the Ministry's payments to CRCs would rise less in response to increased volumes of activity (**Figure 6** overleaf).

3.3 The Ministry and CRCs signed variations to the contracts on 6 June 2017. These increased the Ministry's maximum projected payments to CRCs by £278 million, from 1 August 2017 until the contracts expire in 2021-22.¹³ The combined adjustments increase the maximum projected fee for service payments to CRCs under the contracts to £2.5 billion. This is below the £3.7 billion projected in 2016 but covers much lower volumes of activity than projected at that time. The increased maximum projected payments to CRCs are below the Ministry's estimates when the contracts were awarded.

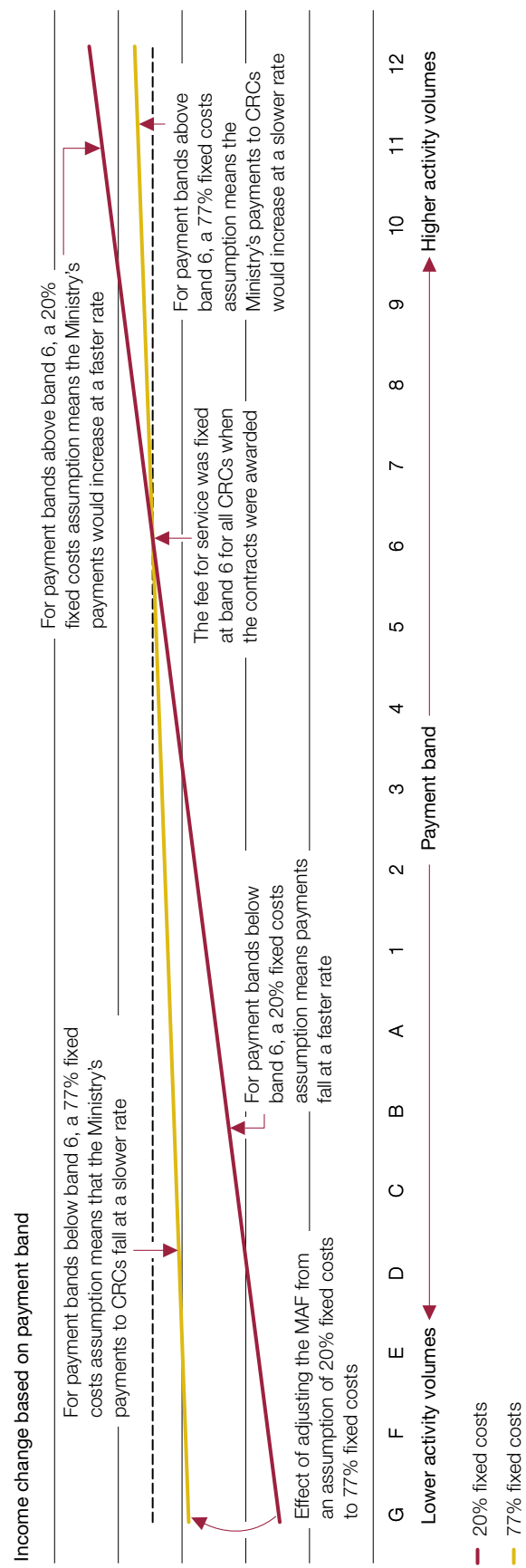
3.4 The Ministry's maximum projected payments arising from the MAF adjustments range from £6 million to £37 million per CRC, adding between 6% and 16% to its maximum projected payments to CRCs.¹⁴

¹³ The modification for the six CRCs owned by Sodexo became effective from 1 July 2017.

¹⁴ Hansard HC, 27 November 2017, Written Question 114769.

Figure 6
Changes to the Marginal Adjustment Factor and its relationship to costs

Illustration of payment bands and levels of income under assumptions of 20% and 77% fixed costs in Community Rehabilitation Companies



Source: National Audit Office analysis of Ministry of Justice data

3.5 The different operational and financial circumstances of CRCs mean that the financial impact of the changes is different for each CRC. The Ministry's additional payments and MAF adjustments in 2017-18 had the following impacts:

- The Ministry applied its change to the MAF equally to all CRCs, so the CRCs reporting the highest percentage of fixed costs did not receive the largest adjustment. The increase in the Ministry's maximum projected payments to the CRC that reported 99.8% fixed costs was 9%. One CRC that reported 84% fixed costs had its maximum projected payments increased by 16%.
- The increase in the Ministry's maximum projected payments to CRCs was greater than forecast losses for seven out of 21 CRCs, and lower than forecast losses for 14 CRCs (**Figure 7** overleaf).
- The 21 CRCs are owned by eight parent companies. The Ministry's maximum projected payments to parent companies increased by between £7 million and £69 million.

Payment by results

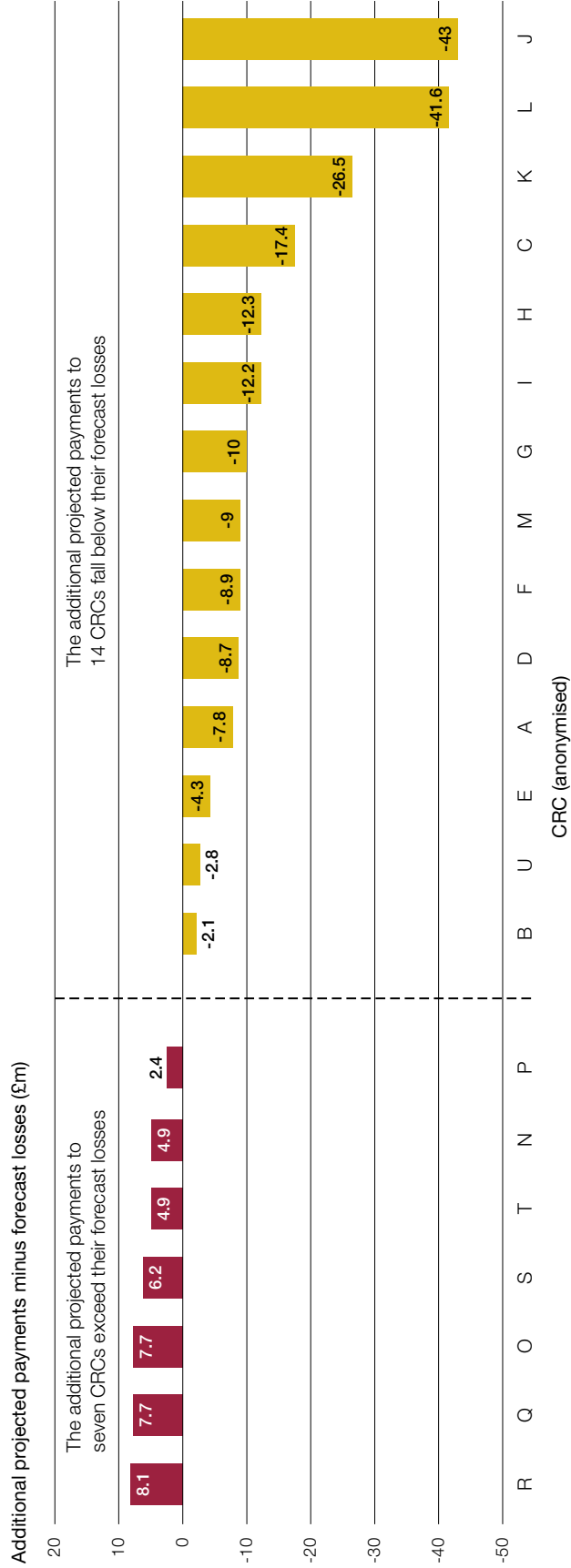
3.6 Under the contracts, the Ministry is required to make payments to CRCs contingent on reoffending outcomes through payment by results. This was intended to give CRCs incentives to develop innovative approaches to reducing reoffending. The Ministry's maximum projected payments to CRCs through payment by results is £567 million over the life of the contracts (18%), compared with £2.5 billion for fee for services under its most recent forecasts. The Ministry will only make payments at this level if CRCs achieve the required results on reoffending. The Ministry makes such payments two years after the year to which they relate to allow time for any potential reconvictions to be processed through the courts.

3.7 CRCs will increasingly depend on income through payment by results as the contracts progress. The Ministry's maximum projected payments for payment by results in 2017-18 and 2018-19 were £32 million and £67 million respectively.¹⁵ Over the life of the contracts, the proportion of total projected payments through payment by results increases from 6% (£32 million) to 28% (£112 million) (**Figure 8** on page 29).

¹⁵ The maximum projected payments under payment by results for 2015-16, the second year of the contracts, reflects two quarterly offender cohorts. Subsequent years in the contracts, 2016-17 up to 2020-21, will reflect four quarterly offender cohorts.

Figure 7
 The Ministry's additional maximum projected payments to Community Rehabilitation Companies minus forecast losses between 2016-17 and 2021-22, by CRC

Seven CRCs' additional projected payments exceed their forecast losses, while 14 CRCs' additional projected payments fall below their forecast losses



Note

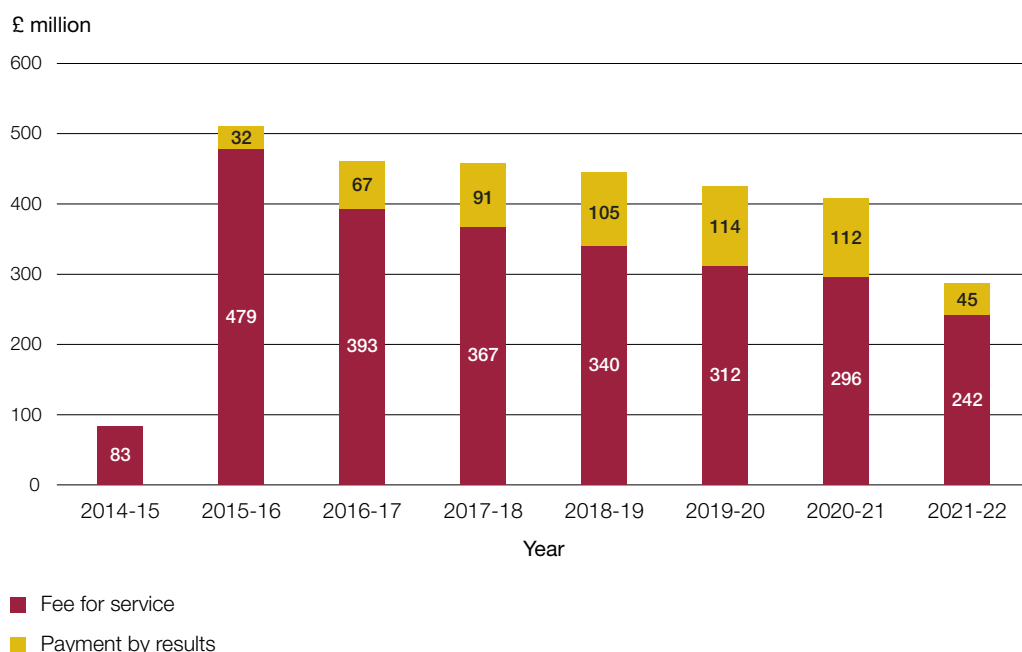
1 Forecast losses are measured by EBITDA (earnings before interest, tax, depreciation and amortisation).

Source: National Audit Office analysis of Community Rehabilitation Companies' financial submissions to the Ministry, and Ministry of Justice data

Figure 8

Distribution of the Ministry's maximum projected payments to CRCs by fee for service and payment by results

The proportion of income available under payment by results increases each year between 2015-16 and 2020-21, the first and final full financial years of the contracts

**Notes**

- 1 The income available to CRCs under payment by results is paid two years after the offender cohorts are formed. For accounting purposes, this income is recorded in the year to which the payment relates rather than the year it will be paid.
- 2 The maximum projected payments under payment by results for 2015-16, the second year of the contracts, reflect two quarterly offender cohorts. Subsequent years in the contracts, 2016-17 up to 2020-21, reflect four quarterly offender cohorts.
- 3 The 21 CRCs estimate that they will receive an additional £77 million between 2016-17 to 2021-22 for providing additional services to the National Probation Service. This income is known as 'fee for use'.

Source: National Audit Office analysis of Ministry of Justice data

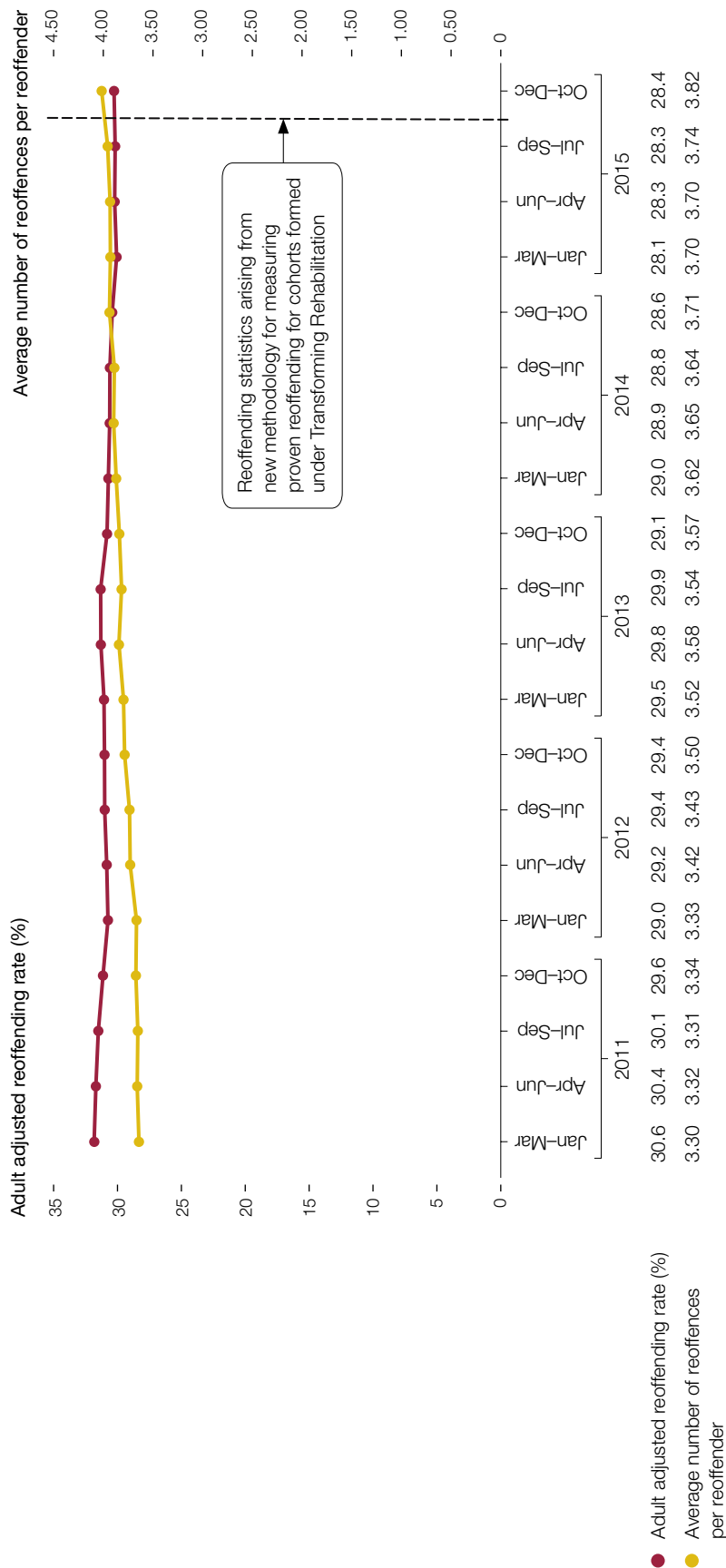
3.8 The first data on reoffending under the contracts were published on 26 October 2017. The Ministry uses adjusted adult reoffending rates to determine the level of payments by results to CRCs, measuring both the proportion of offenders who reoffend and the frequency of re-offences per reoffender. The reoffending rate for England and Wales for the first Transforming Rehabilitation cohort was 28.4%, a reduction of 2.2 percentage points against the rate in January to March 2011 of 30.6%. Results for the first available quarter show that 13 of the 21 CRCs made statistically significant reductions in the reoffending rate in the October to December 2015 cohort when compared to the 2011 baseline rates.¹⁶ The first performance payments to CRCs informed by reoffending data are due in January 2018, once data on the frequency of reoffending are published. The most recently published data show that the frequency of reoffences per reoffender is increasing, which may impact on CRCs' income (**Figure 9** overleaf).

¹⁶ Ministry of Justice, *Final and interim proven reoffending statistics for the Community Rehabilitation Companies and the National Probation Service*, 26 October 2017.

Figure 9

Adjusted adult reoffending rate, between January to March 2011 and October to December 2015

The adjusted adult reoffending rate has reduced by 2.2% between January to March 2011 and October to December 2015 in England and Wales



Notes

- 1 The data source for reoffending statistics changed for the October to December 2015 cohort. The Ministry estimates this change increases the reoffending rate by around 0.5 percentage points.
- 2 The latest published statistics report on offenders who are released from custody, received a non-custodial conviction at court, or received a caution within a three-month period, for all measures of reoffending. Previously, a 12-month cohort was used.
- 3 The Ministry published an adjusted reoffending rate for adults to take account of the influence that differences in the composition of the offender cohort can have on reoffending rates.
- 4 An adjusted reoffending rate for juvenile offenders is not yet available.

Source: National Audit Office analysis of Ministry of Justice data

Appendix One

Our investigative approach

Scope

1 We conducted an investigation into concerns raised with us about the changes announced by the Ministry of Justice in July 2017 to its contracts with Community Rehabilitation Companies (CRCs) and the additional funding they will receive under the revised contracts. This report sets out the facts in relation to:

- why the Ministry adjusted CRCs' contracts;
- how the Ministry adjusted the contracts; and
- the financial and other implications of the adjustments to the contracts.

Methods

2 In probing these issues, we:

- examined the percentage changes in the CRCs' volumes of activity between 2015-16 and 2017-18;
- analysed the volumes of offenders supervised by CRCs;
- analysed the payments made by the Ministry to CRCs between 2014-15 and 2016-17 and its maximum projected payments to CRCs over the life of the contracts;
- analysed published information on CRCs' performance against service level indicators;
- analysed the Ministry's data on service credits;
- reviewed the Ministry's documents about its adjustments to the contracts and its business case for the adjustments;
- reviewed the financial submissions provided as part of the Ministry's external assurance exercise to understand the financial positions of the CRCs and their reported costs;
- analysed the changes the Ministry made to its contracts with CRCs, including the £278 million additional projected payments to CRCs arising from its change to the marginal adjustment factor, and its impacts; and
- analysed adult reoffending data published by the Ministry.

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