Ministry of JUSTICE | Procurement

**REHABILITATION PROGRAMME**

**MARKET ENGAGEMENT, MAY 2013**

**Payment Mechanism – Straw Man**

## INTRODUCTION

This document sets out our "Straw Man" payment mechanism proposal for how we will pay for the parts of the Rehabilitation Programme that will be put to market. We would like to have comments from potential providers on our proposal and aim to use these to refine the payment mechanism before it is finalised in the contracts.

Potential providers can submit the feedback they have on the proposal using the online questionnaire at http://www.justice.gov.uk/transforming-rehabilitation/prior-information-notice where we have included some key questions for potential providers to respond to. These can also be viewed in Annex 2 to this document. To allow us time to consider responses, the deadline for submitting feedback is 5th July.

Please note that further iterations of the payment mechanism including a draft contractual schedule may be published later in the market engagement process for further feedback and comment.

## PAYMENT MECHANISM SUMMARY – KEY DESIGN FEATURES

### Fee For Service

- Annual price paid in twelve equal payments made monthly in arrears
- Subject to an annual learning curve discount to drive continuous improvement
- Providers will bid against a predicted baseline volume range, weighted for sentence type & length
- At the end of each contract year, the payment is reconciled to the actual volumes recorded, with a retrospective payment or clawback applied if actual volume is shown to have been outside the predicted range
- Deductions made for failure to deliver the orders of the court to specified time and quality

### Payment by Results

- Binary & Frequency measure with a binary "hurdle"
- Quarterly cohorts (to reduce the time lag) with annual top-up payment for genuine improvement against annualised targets
- Monthly 'Foundation Payment' of part of the providers profit component paid upfront for expected achievement of quarterly PbR targets
- Payment only for achieving demonstrable results, with clawback available for underperforming and higher payments for further improvements over minimum requirement
- Large financial deductions / termination for increase in re-offending rates

**FEE FOR SERVICE**

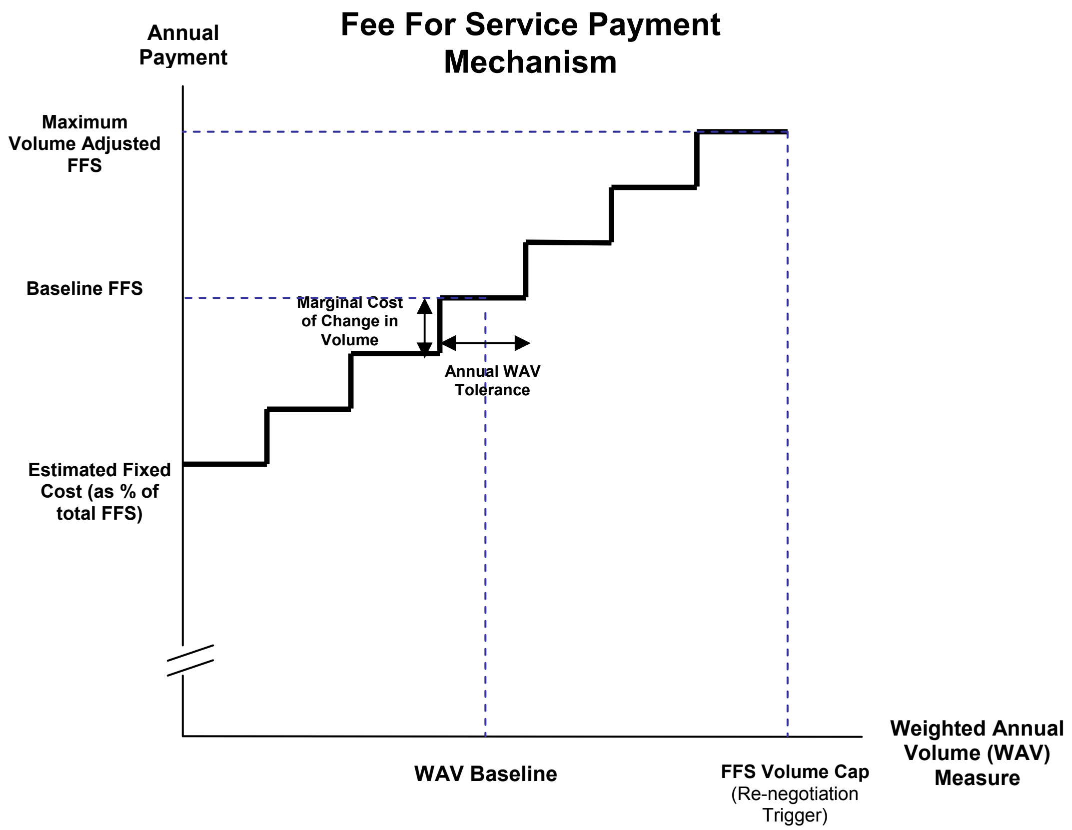
The Fee For Service (FFS) is payment for mandated activities that deliver through the gate services, the sentence of the court and licence conditions to time and quality.

We recognise that volume risk - i.e. the risk that providers are required to deliver services for a larger or smaller number of offenders than expected – is a serious concern, and therefore the risk needs to be shared between Government and providers.

Whilst the MoJ is best place to manage factors that could make significant changes to volumes, we also need to ensure that providers are still incentivised to focus firmly on reducing reoffending.

The FFS component will therefore be a fixed price for services with a volume related adjustment where changes to volume levels fall outside of an appropriately determined tolerance range. This volume tolerance range recognises that the likely reason for a *significant* increase or decrease in volume is most likely to be due to external factors not within the control of a provider

The graph below shows the key components of the FFS mechanism.



The details of the FFS mechanism are described below:

**Annual Payment**

The Annual Payment is a fixed fee for the delivery of all services against the predicted volume range for the coming year.

Twelve equal payments will be made monthly in arrears. At the end of each contract year, the Annual Payment is reconciled to actual volumes over the year. A retrospective payment or clawback will be applied if, at the end of the contract year, actual volume is shown to have been outside the predicted range.

At the end of each contract year, the fixed price point for the coming year will be determined based on the predicted volume range. This will be agreed with the provider prior to the contract year commencement.

**Weighted Annual Volume (WAV) Measure**

Volumes will be measured using a single measurement unit. This single measurement of volume is based on the number of offender starts and comprises differently weighted service requirements. Payment will then be pro-rated over twelve months.

The varying service requirements will be weighted according to the level of resource typically required to deliver them. Therefore an increase in the number or length of a highly weighted start type within the volume mix would mean a greater increase in the overall volume measurement than if there was a corresponding increase in the number or length of a lesser weighted start type.

The WAV measure captures the net changes in overall resource requirements for different sentence volumes and types and will be as high level as possible so that this does not unduly influence the way in which providers deliver the sentence.

Certain sentence requirements will require more resource than others, irrespective of the way they are delivered, depending on type of sentence and its length (e.g. 100hrs vs 200hrs of CP or rehabilitation order vs accredited programme) Factoring in the resource related to the sentence and requirement type means that “sentencing trend risk” as well as overall “volume risk” is appropriately shared, as indicated in the example calculation table below:

| | Sentence Type | Sentence Weighting | Annual Volume of Offenders | Weighted Annual Volume (WAV) |
|---|---|---|---|---|
| **Baseline Scenario** | Sentence X | 1 | 100 | 100 |
| | Sentence Y | 2 | 100 | 200 |
| | Sentence Z | 3 | 100 | 300 |
| | | **TOTALS:** | **300** | **600** |
| | | | | |
| **Volume Scenario 1** | Sentence X | 1 | 50 | 50 |
| | Sentence Y | 2 | 125 | 250 |
| | Sentence Z | 3 | 100 | 300 |
| | | **TOTALS:** | **275** | **600** |
| | | **Variance from Baseline:** | **- 25** | **0** |
| | | | | |
| **Volume Scenario 2** | Sentence X | 1 | 10 | 10 |
| | Sentence Y | 2 | 10 | 20 |
| | Sentence Z | 3 | 200 | 600 |
| | | **TOTALS:** | **220** | **630** |
| | | **Variance from Baseline:** | **- 80** | **+ 30** |
| | | | | |
| **Volume Scenario 3** | Sentence X | 1 | 200 | 200 |
| | Sentence Y | 2 | 150 | 300 |
| | Sentence Z | 3 | 10 | 30 |
| | | **TOTALS:** | **360** | **530** |
| | | **Variance from Baseline:** | **+ 60** | **- 70** |

The detail of the WAV measure is currently being developed, however the indicative categories of sentence requirements whose weighting may have direct influence on the WAV calculation include:

- Manage the sentence for a Community Order or Suspended Sentence Order
- Deliver a Supervision Requirement
- Deliver an Unpaid Work Requirement
- Deliver Accredited Programme (eg Women Offenders Programme)
- Deliver Other Intervention (eg supporting Mental Health treatment)

**WAV Baseline**

For the purposes of tendering we will use historical data to project the year 1 WAV Tolerance range for each CPA.  This will be used as the baseline tolerance range for the purposes of tendering.

**Baseline FFS**

The fixed Annual Payment that the provider proposes is necessary to achieve delivery of services at volume levels within the WAV Baseline tolerance range. <u>This is the one variable of the payment mechanism that providers will bid against.</u>

## Annual WAV Tolerance

Represents defined ranges of the WAV unit measurement, within which a fixed price will not be adjusted for changes in volume. Having a volume tolerance range within which the FFS will not change reduces any perverse incentive for the provider not to act in a way to reduce reoffending rates.

The size of the WAV Tolerance ranges represent the level of volume risk passed to the provider. The wider the bands, the greater the risk passed to the provider. We will set WAV Tolerance ranges that are consistent and symmetrical either side of the relevant baseline, to reflect that significant changes in volume will likely be due to structural system changes outside of the control of the provider. Providers take volume risk within the WAV Tolerance ranges; MoJ takes volume risk between the ranges.

The tolerance around the annual Baseline WAV for each CPA will be set using historical variability in volumes, and will therefore vary between CPA.

## Price Adjustments for Changes in Volume

Where volumes move from one WAV Tolerance range to another there will be an adjustment to the fixed price Annual Payment. A fixed % change (increase or decrease) is applied for each Annual WAV Tolerance range beyond the baseline.

The adjustments recognise that large volume changes will likely be due to structural changes. The size of the adjustment will be based on estimated marginal cost of service delivery. To enable comparison of bids, this % adjustment will be fixed and consistent for all bidders.

## Maximum Price Band

These volume adjustments to the fixed annual price will be applicable for up to a 100% increase in volume relative to the WAV Baseline. For increases in volume beyond 100% contract renegotiation will be triggered.

## Minimum Price Band

Volume adjustments to the fixed annual price will also be applicable for up to a 50% decrease in volumes relative to the WAV Baseline. For decreases in volume beyond 50% contract renegotiation will be triggered.

## Indexation

The indices used for indexation of the FFS payment shall be prescribed by the MoJ.

**Performance Management**

A performance mechanism will allow MoJ to manage contracts robustly and make deductions where the orders of the court are not delivered in accordance with the quality standards set out in the contract.

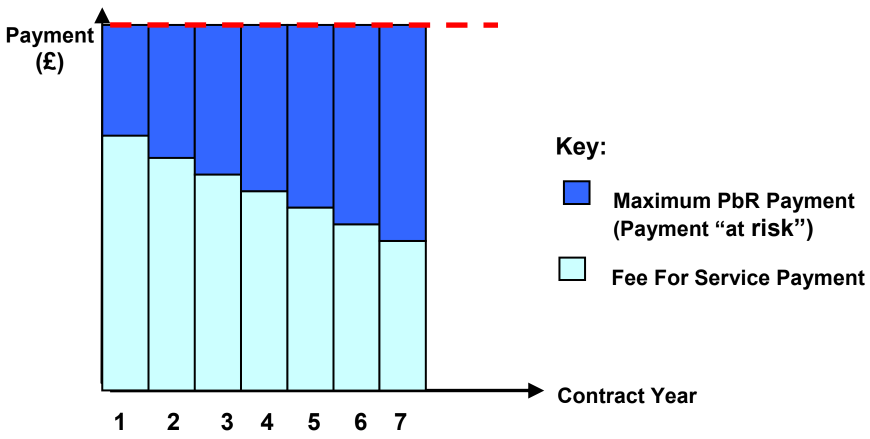
Key Performance Indicators (KPIs) will be used to periodically measure the quality of service delivery, ie whether the orders of the court have been delivered as required. Failure to attain pre-determined KPI targets will permit MoJ to deduct a proportion of the subsequent FFS payment. These KPIs will also be linked to non-financial performance mechanisms, such as issuance of Improvement Notices and ultimately contract termination.

**Learning Curve Discount**

An annual Learning Curve Discount will be applied to help drive continuous improvement. The discount will be set by the MoJ as a % reduction in the FFS for each year of the contract. To achieve the same level of profitability year on year providers will be required to either:

- improve their efficiency whilst achieving the same level of reoffending outcomes; or
- improve their reoffending outcomes to achieve a greater % profit and offset the FFS reduction.

This is illustrated in the diagram below:



## PAYMENT BY RESULTS (PbR)

The PbR element of the payment mechanism is designed to incentivise bidders to continuously innovate and improve performance throughout the life of the contract and, reduce re-offending rates significantly beyond historic levels. This model is designed to pay the provider the profit component of their total cost model only where they achieve significant improvements in reoffending rates.

The PbR mechanism is described below.

### Offender Cohorts

The PbR measurement will be based on a series of offender "cohorts". These are the groups of offenders whose re-offending will determine the providers success or otherwise at reducing re-offending rates. Cohorts will be built up on a quarterly basis and will include:

- all offenders released from a custodial sentence;
- all offenders who begin a community order (CO);
- all offenders who begin a suspended sentence order (SSO).

The cohorts will exclude:

- offenders who do not receive one of the above disposals
- offenders *initially* assessed by the public sector as high risk of harm; MAPPA and public interest cases**;**
- foreign national offenders subject to deportation.

A single cohort will be constructed on a 3 month basis in each CPA. It will not be segmented by the type of sentence although statistics for each type of sentence will be collected for monitoring purposes.

Cohorts will exclude offenders deemed as "high risk of harm" in the initial risk assessment, current MAPPA offenders and a small number of public interest cases as these will be managed by the public sector probation service.

In instances where an offender's risk profile escalates to a point that they need to be transferred to the public sector probation service, the offender will remain within the cohort for PbR measurement and payment purposes.

Such instances will be monitored and measured through the performance mechanism with appropriate KPIs attached to incentivise appropriate behaviour in managing risk.

### PbR Metrics

A proven re-offence will be counted as any offence committed within a one year follow-up period, following an offender's entry into the cohort, which then attracts a court conviction or caution within that one year follow-up period or within a further six month waiting period to allow for cases to work their way through the courts.

To maintain consistency and maximise transparency offences will be counted using the National Statistics 'proven re-offending' measure and therefore counted as proven re-offences if they meet *all* of the following criteria:

1. They were committed in England or Wales.
2. They were prosecuted by the police
3. They are recordable on the Police National Computer (PNC)
4. They are proven through a caution or court conviction. Offences that are not proven, or which meet with other responses from the Criminal Justice System, are not counted.
5. The offence is not a breach offence, i.e. breach of a court order.

We are committed to only rewarding in full for complete desistance from crime; however the payment mechanism will also take into account each further offence so that providers cannot neglect the most difficult offenders and those who have already reoffended, and so that every victim of crime is taken into account in providers' reward payments.

Therefore there will be two measures for re-offending used to calculate the PbR payment. These include:

1. Binary metric = measures the percentage of offenders that are convicted of an offence within a 12 month period.

2. Frequency metric = measures the rate of offences committed by offenders within a cohort within a 12 month period.

PbR payments will be allocated on the basis of performance against the binary measure and the frequency measure, with a percentage of the total funding available linked to each.

However, to receive *any* PbR payment, a provider will have to have improved performance on the binary metric to a point of statistical significance within the given CPA, regardless of performance against the frequency metric. This reflects the importance placed on achieving complete desistance from re-offending.

**Reducing Re-offending Baseline**

A baseline for both binary and frequency of reoffending will be set for each CPA based on average quarterly reoffending figures for the most recent year that data is available.

This baseline will be adjusted once the make-up of the cohort is known (at the end of the 3 month cohort build up period) to account for changes in the offender mix. OGRS Scores for the cohort will be used to make this adjustment.

**Reducing Reoffending Targets**

Statistically significant points (SSPs) will be set that identify the appropriate minimum changes to the re-offending rate that would need to take place before any PbR adjustments are applied to the payment received by the provider.

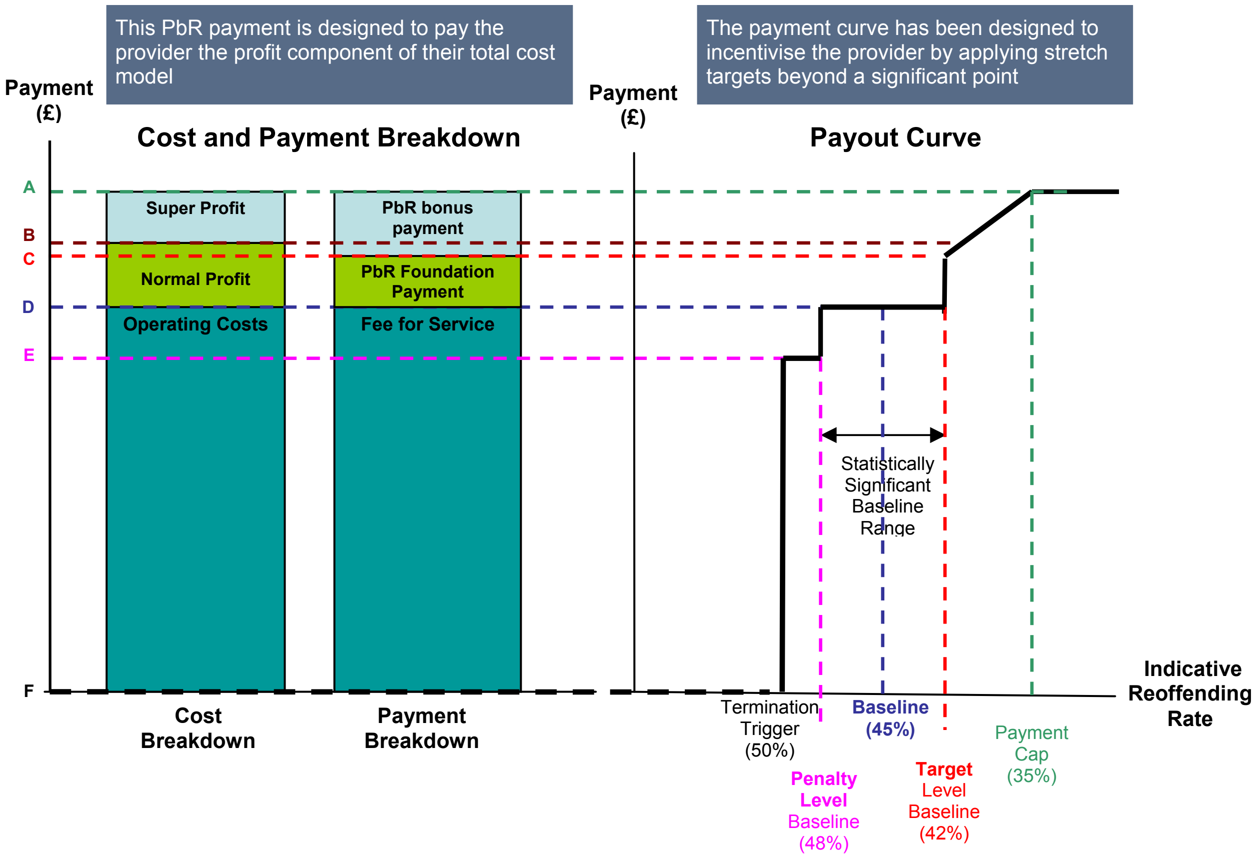
The higher SSP will represent the minimum improvement in re-offending rates expected by the MoJ (Target Level Baseline), whilst the lower SSP will represent the level of re-offending rates significantly worse than the baseline and therefore considered unacceptable (Penalty Level Baseline). This will result in financial deductions to the provider.

PbR payments will only be made through the achievement of a demonstrably significant improvement in re-offending over the agreed CPA PbR Baseline.

These targets are intended to discourage providers from allowing any increase in the re-offending rate through disinvestment in services as this would lead to financial deductions and ultimately contract termination. Contract termination could result from any single large increase in reoffending rate (Termination Trigger) or from allowing any repeated failure to achieve at least the rates within the significant baseline range.

### Payment Curve

The payment curve has been designed to incentivise the provider by applying stretch targets beyond a SSP, as indicated in the example below:




This diagram demonstrates the relationship between indicative levels of performance and the associated levels of payment and expected return to providers. These various payment scenarios are further described in the following table. All %s are purely for illustrative purposes and will be bid as part of the competition process:

| Payment Curve Scenario | Description | Indicative Impact on profitability | Rationale |
|---|---|---|---|
| **A** | The re-offending rate is improved *substantially* beyond the upper (positive) SSP | Additional Profitability above a purely FFS model | A maximum payout is only achieved for a very large reduction in re-offending rates. This incentivises providers to continue to innovate to make improvements in reoffending beyond the minimum target.<br><br>This bonus payment is capped at an absolute, affordable figure. The re-offending rate needed to achieve this will depend on the number of offenders in the cohort |
| **B** | The re-offending rate is improved beyond the upper (positive) SSP | "Normal" profit levels achieved | A total normal profit is paid in addition to the FFS. Only at this point is the provider receiving the 'full' payment equivalent to payment under a non-PbR model. Again this incentivises the provider to continue to improve reoffending rates beyond the minimum target level. |
| **C** | The re-offending rate is at the upper SSP | Some profit achieved but not full "normal" profits | For a demonstrable improvement in reoffending rates, some normal profit is paid in addition to the FFS. |
| **D** | The re-offending rate is within the statistically significant baseline range | 0% Profit | For no demonstrable improvement in reoffending rates, no profit is achieved, only the FFS is paid |
| **E** | The re-offending rate is at or below the lower (negative) SSP | c.10% Penalty<br><br>Contract Termination | Initially a significant % of the FFS is recovered as a financial penalty. For repeated instances, contract termination is triggered.<br><br>This is designed to be of a sufficient level that incentivises providers not to disinvest in services without giving them an uncapped financial risk over the life of the contract. |
| **F** | The re-offending rate is *substantially* below the lower (negative) SSP | Contract Termination | Unacceptable performance will result in contract termination. |

**Timing of PbR Payments / Cash Flow**

The time lag to measure PbR outcomes is substantial (25 months including 3 months to form cohort + 12 months re-offending window + 6 months court waiting time + 4 months for data analysis) and therefore the PbR Foundation Payment is designed to ease the provider's cash flow. The Foundation Payment is set at a level that is the expected payment for achieving the quarterly PbR targets. This is part, but not all, of the provider's "normal profit".

This will be estimated and paid on a monthly basis, together with the FFS. At the point at which PbR results are finalised, this payment will be clawed back if the quarterly targets have not been achieved (see Annex I).

**PbR Volume Risk**

To ensure that the MoJ retains volume risk related to PbR, payments will be adjusted to take account of volumes as follows:

Binary payout (offenders complete desistance over 12 month period) =
(reduction in re-offending rate) x (£ per offender amount) x (Number of offenders in the cohort)

Frequency payout (offenders reconviction events over 12 month period) =
(reduction in re-offending rate) x (£ per % point change in re-offending rate) x (number of offenders in the cohort / number of offenders in the baseline cohort)

For affordability reasons, the total PbR payment available will not be adjusted for changes in volumes. However, where volumes increase, providers will achieve the maximum cap on payments at a lower percentage change in reoffending rates.

**Annual Reconciliation**

The payment mechanism will seek to balance the need to give providers certainty early with the desire to pay for genuine improvements in reoffending rates. To bring forward timing of PbR payments we have set the mechanism to pay out based on targets for 3 month cohorts. Targets for 3 month cohorts are potentially higher than they would be for annual cohorts where the cohort is small and there is greater variability in the level of reoffending for the 3 month cohort relative to the larger annual cohort.

Where a provider does not meet the comparatively high quarterly cohort targets but has still made a statistically significant impact on reoffending rates over the year (i.e. would have met the lower annual cohort target), it is appropriate that the provider is paid for this as they have achieved a result.

Therefore we will "top up" the quarterly PbR payments made to a provider with an annual PbR payment, on the same basis, based on the provider's annual re-offending rate.

**For example:-**

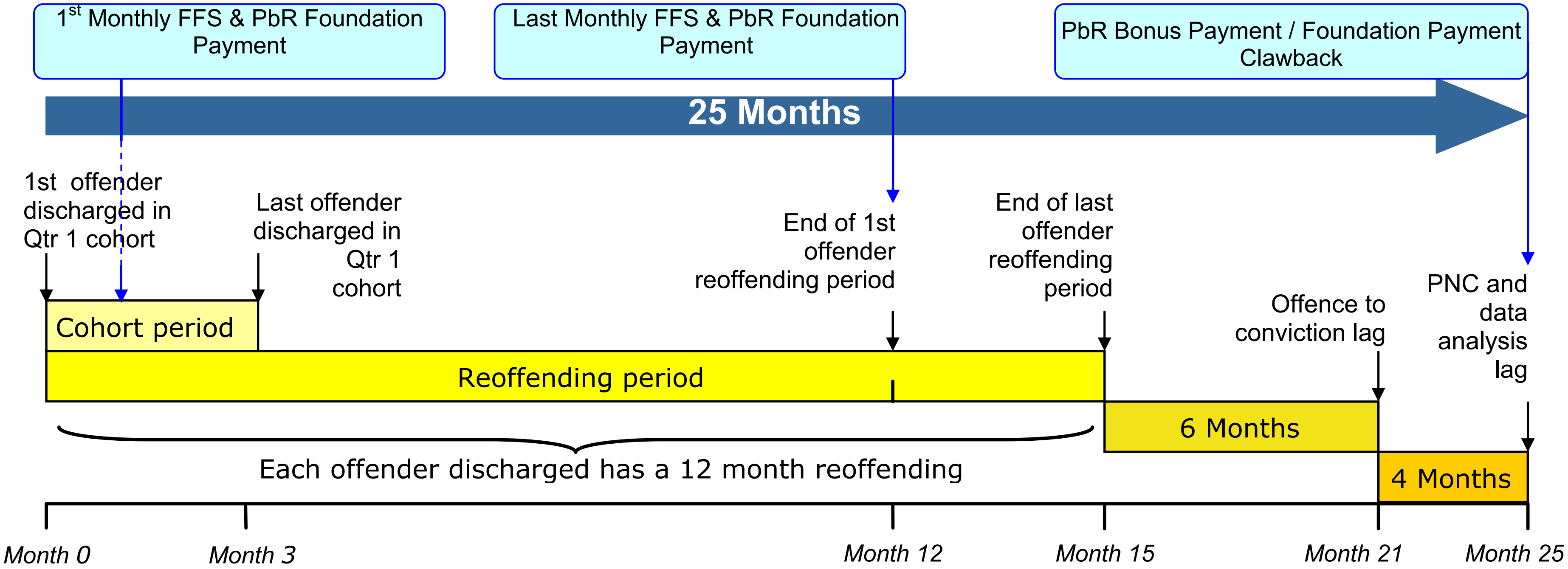
Quarterly SSP Target – 5% points
Annual SSP Target – 3% points

Quarterly cohort size – 1000
PbR Payment Per offender - £100

Results:-

| | Reduction in Reoffending Achieved | Quarterly PbR Payment Due | "Top-up" through Annual Payment |
|---|---|---|---|
| Quarter 1 | 3% points | **£0** (Target not achieved) | |
| Quarter 2 | 3% points | **£0** (Target not achieved) | |
| Quarter 3 | 5% points | **5000** =1000*£100*5% | |
| Quarter 4 | 5% points | **5000** =1000*£100*5% | |
| Annual Top Up Payment | 4% points | | **6000** =(4000*100*4%) – 5000 – 5000 |
| **Net Payment Due** | | | **16000** =5000 +5000 + 6000 |

**Annex I**
**Payment by Results – PbR Foundation Payment / Cash flow**



**Annex 2**
**Feedback Questionnaire**

| | |
|---|---|
| **1.** | Are there any elements of the proposed payment mechanism that are not clear? Where would you like additional clarity? |
| **2.** | Do you think the proposed structure of the Fee for Service (FFS) element of the payment mechanism is appropriate for the services being contracted? If not, what are your concerns? How would you suggest the mechanism be improved? |
| **3.** | Do you think the proposed structure of the Payment by Results element of the payment mechanism is likely to incentivise providers to focus on reducing reoffending? If not, what are your concerns? How would you suggest the mechanism be improved? |
| **4.** | The model proposes that contractors put a substantial part of their total fee (cost plus margin) at risk for reductions in reoffending. What minimum level of "at risk" payment would you consider to be sufficiently incentivising? What maximum level of total fee "at risk" would be acceptable? |
| **5.** | Are there any elements of the proposed payment mechanism that would incentive the "wrong" behaviours? If so, what are these and what behaviours could they drive? |
| **6.** | Do you have any other comments regarding the proposed payment mechanism? |

**Please note the deadline for submitting feedback is 5th July 2013**.

**Future iterations of the payment mechanism including a draft contractual schedule may be published later in the market engagement process for further feedback and comment.**