



National Audit Office

Principles paper

by the National Audit Office

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

DECEMBER 2013

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Summary

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

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

Public services being 'marketised'

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

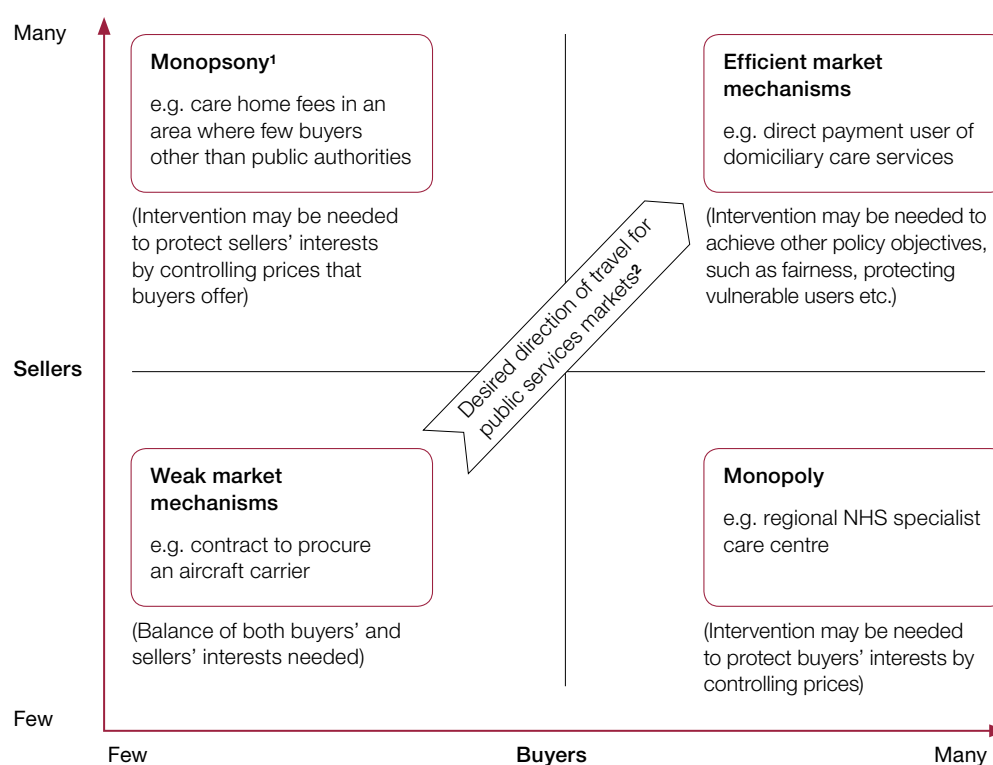
Opportunities and risks

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

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

Figure 1

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



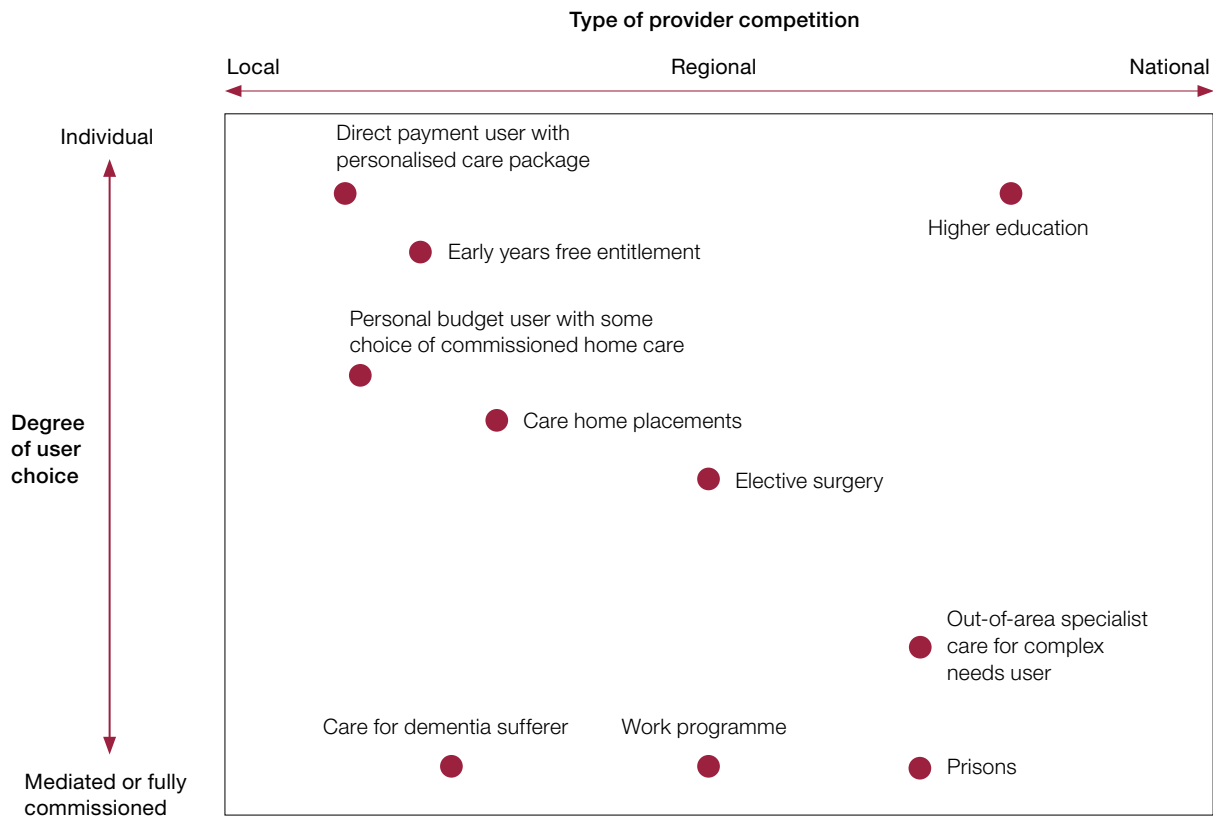
Notes

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

Source: National Audit Office

Figure 2

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



Source: National Audit Office

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

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

The roles of government nationally and locally

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

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

Paying the right price for services

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

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

Value for money of deciding appropriate prices

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

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

Delivering public services through markets

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

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

National principles – policy departments as ‘system operators’

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

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

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

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

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

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

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

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

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

Local principles – local authorities as ‘market stewards’

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

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

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

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

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

Principle six: The price sustains supply at acceptable levels

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

Principle seven: Quality is acceptable

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

Principle eight: Users are well informed about quality

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

Part One

Public markets and the department's role

1.1 In recent decades, the government has moved away from providing services directly. In the 1980s and 1990s it focused on privatising state industries, but has since increased the importance of market mechanisms in providing public services such as health and education. Provision through markets involves a number of providers competing to provide services with prices determined by market forces. Departments are still, however, responsible for ensuring that they achieve national policy outcomes, even where markets operate locally, for example in education and social care.

1.2 This part examines the relevant department's role in overseeing market provision. It shows that:

- departments need to understand system-wide supply and demand issues to ensure adequate levels of provision;
- departments need to understand market structures and developments to identify potential market failures and intervene if necessary; and
- competition law may impact on public markets and departments must work with the relevant bodies to raise awareness and enforce competition rules if necessary.

The part compares and contrasts the characteristics of the two markets we examined: social care for adults (which is comprised of two main types: residential care homes, and home care); and early years childcare, both of which use 'marketised' provision and have done so for a number of years.

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

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

1.3 The characteristics of a market are important in determining the risks to value for money, and how the government should address them. Relevant characteristics include the government's purchasing power versus market share represented by private payers, profit levels, the sustainability of provision, and regional variations. For the responsible department to have effective oversight it must be well informed about the market's characteristics and the effectiveness of the market's operation.

1.4 The department should understand market trends and projections of supply and demand for the services in question. This includes what affects levels of need, to ensure that sufficient supply exists nationally to meet anticipated demand. Demand for care for example, overall, is projected to increase from 1.3 per cent to 1.9 per cent of gross domestic product by 2050, largely because of the projected increase in the older population. The number of people in the UK aged 85 years or over is projected to increase from 1.4 million in 2011 to 2 million in 2021, and reach nearly 3 million by 2031.¹¹

1.5 Monitoring occupancy rates nationally and regionally, and rates of new entry and exit from the market, should indicate how far projected trends in demand may be accommodated (or otherwise). In addition, scenario planning and risk modelling that stress tests the effect of different assumptions on providers' financial viability, can also help to assess the risks to provision in the market.

1.6 It is also important for the government to anticipate the potential market effects of policy changes and reforms. For example, in the longer term the government's dominance as a buyer in the market may be diluted by government policy on personalisation. Personalisation gives the individual user more choice and control over the care services they choose to buy to meet their assessed needs. The government has rolled out personal budgets in social care in the last few years to meet the intention that 70 per cent of all users should have a personal budget by 2013. Similar mechanisms for user empowerment have been announced in health (personal health budgets) and for educational special needs.

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

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

1.7 The early years childcare provider and social care provider markets are both characterised by:

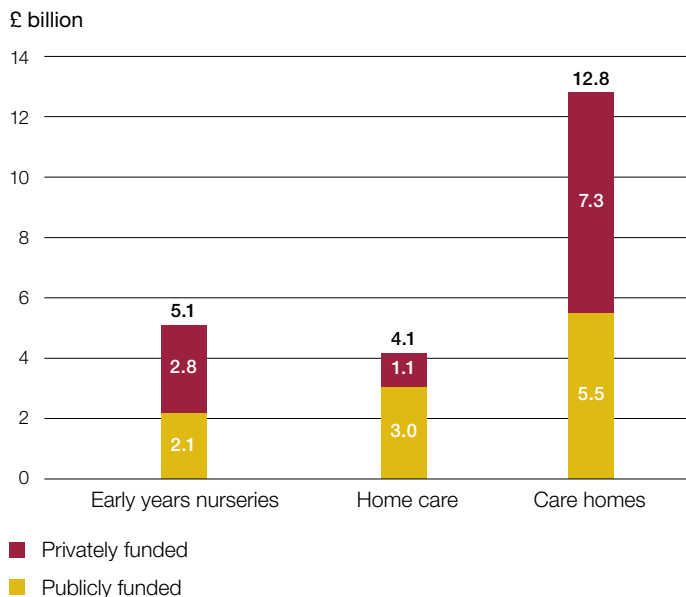
- thousands of small private, voluntary and independent providers in a highly fragmented market;¹²
- a relatively small number of large operators, or chains of providers with relatively low levels of concentration nationally, but higher levels in some local areas;
- relatively easy entry to the market by new providers; and
- voluntary, charitable and third-sector providers whose motivation for entering the market may not be primarily profit-centred, as well as a large number of 'for-profit' providers.

The markets differ, however, in the split between public and private funding (**Figure 3**). In markets or areas of the country where the proportion of publicly funded services is high, its predominance can give the local authorities greater power in the market.

1.8 An outline of the main characteristics of the social care sector and its policy context is at **Figure 4**, and similar information for the nurseries sector is in **Figure 5** on page 17.

Figure 3
Annual value of service provision by funding source (£bn)

Public service markets typically have private markets operating alongside them



Note
1 Figures for early years privately funded market are estimates based on a small market survey.

Source: National Audit Office analysis of Laing & Buisson data

Figure 4

Social care sector

Description	Social care supports vulnerable people with certain physical, cognitive or age-related conditions in carrying out personal care or domestic routines, and supports people in building social relationships.
Policy context	<p>The Department of Health (the Department) sets the policy framework for social care and part-funds its delivery. At the heart of government policy on social care is the principle that people should control their own care and support and that personal budgets and direct payments, backed by clear, comparable information and advice, will empower individuals and their carers to make the right choices for them. The Department's goal remains that everyone who is eligible for ongoing non-residential care should have a personal budget, preferably as a direct payment. The Care Bill delivers the commitments in the white paper which set out the government's intention to legislate to ensure that everyone can control their own care and support by giving them an entitlement to a personal budget.¹</p> <p>Local authorities have a statutory duty to provide accommodation to anyone – publicly or self-funded – who has an urgent need for residential care which is not otherwise available. Under the NHS and Community Care Act 1990 local authorities have the powers to provide or arrange care services for anyone in urgent need. The Care Bill delivers the white paper's commitment to giving local authorities a more significant leadership role, shaping the local market and working with the NHS and others to integrate local services.²</p>
Service characteristics	<p>Personal budget holders decide how to best meet their care needs. They may choose to take their personal budget in cash as a direct payment.³ Other common options include for the local authority to 'manage' the budget for the user, and in some cases for the user to accept a more limited degree of choice of service provider (procured within existing local authority contracts).</p> <p>Certain characteristics of social care present particular challenges for providing it through a market. It is hard, for example, to measure the value added (how quality of life is improved by the care received) by particular care providers. This can make it more difficult for service users to compare different services without having experienced them. Users may have to make significant purchasing decisions, such as which care home to enter, with little preparation and in periods of emotional distress.⁴</p>
Market characteristics	<p>The market is well established and the current system dates back to the NHS and Community Care Act 1990. Local authorities have traditionally provided publicly funded care services directly. Since the early 1990s however, local authorities increasingly purchased care from independent providers. Private providers now supply over 80 per cent of both care home beds and home care nationally. Other characteristics of the sector include the following:</p> <ul style="list-style-type: none"> ● A substantial corporate care home sector, though the sector remains relatively fragmented. The market share of the ten largest 'for-profit' providers has dropped from 28 per cent to 24 per cent approximately since 2008.⁵ The home care sector is more highly fragmented than the care home sector. ● The balance of market power remains firmly with local authorities, which are the largest single purchasers of care home beds in most parts of the country.⁶ ● Care home closures remain at a historically low level, and entry of new capacity continues to exceed the loss of capacity from closures.

Figure 4 *continued*

Social care sector

Public and private market shares

In the care home sector, self-funders or private payers (including local authority funded residents with 'top-ups') are estimated to account for 57 per cent of all older and physically disabled residents in independent sector care homes,⁷ whereas publicly funded residents (mainly local authority) represent under half (43 per cent) of the market. The ratio of private payers to publicly funded residents varies from area to area, and home to home. In home care, the publicly funded share of the market is close to three-quarters of the market.

Regional market variation

In more affluent areas of England (for example parts of the south-east) the proportion of publicly funded residents in care homes is much lower than the national average and the local authorities will be a more marginal presence in the market. Fees that local authorities pay in these areas are some of the highest in the country (£600 per week and above is common). By contrast, less affluent areas such as parts of the north of England, the local authority is typically more dominant in the local care market and in these areas local authority fees can be less than £400 per week.

Similar variations as exist in the care home market are found in the fees paid for home care between different parts of the country, for example hourly rates are £18.50 in West Sussex whereas only £9.70 in Liverpool.⁸

Levels of spare capacity in the care home sector vary significantly with the highest occupancy rates (95 per cent) in Greater London, while the lowest occupancy rates experienced are in the north of England, particularly in the north-east (88 per cent).⁹

Notes

- 1 HM Government, *Caring for our future: reforming care and support*, Cm 8378, July 2012. HM Government, *The Care Bill explained*, Cm 8627, May 2013.
- 2 According to the 2011 census for England, more than half of 85-year-olds and over have care needs, which limit their day-to-day activities.
- 3 They may be given choices as to how they manage their budget and whether they wish to employ a carer directly as long as they (or their representative) have been assessed as able to manage their own budget.
- 4 Institute for Government, *Making public service markets work*, July 2013.
- 5 This has been caused largely because of the redistribution of care homes to a broad band of providers following the exit of the former largest provider Southern Cross in 2011.
- 6 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 100.
- 7 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, pp. 221–2.
- 8 Which?, *The hourly cost of personal care*, October 2013. Rates shown are the hourly charges made by local authorities for commissioned personal care.
- 9 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 149.

Source: National Audit Office

Figure 5**Early education and childcare sector**

Description	<p>All three- and four-year-olds are entitled to 15 hours per week of free education, for 38 weeks per year. Children can receive the entitlement for two years before reaching compulsory school age, the term after they turn five. Some 1.2 million children receive the free entitlement. The Department for Education (the Department) has recently extended the entitlement to disadvantaged two-year-olds from September 2013.</p>
Policy context	<p>The Department sets the policy framework for children's early years education and provides early years entitlement funding for this provision to local authorities through the Dedicated Schools Grant. At an estimated cost of £2.1 billion in 2012-13, the free entitlement is the Department's main financial intervention in children's early education. Since April 2011, local authorities calculate formula spending for the early years entitlement using the Department's framework – the Early Years Single Funding Formula – which is designed to harmonise funding base rates across provider types in the private, public and third sectors. The funding formula calculation can include a selection of supplements to cover deprivation, quality, flexibility, sparseness and other specific needs.</p> <p>The Childcare Act 2006 placed a statutory responsibility on local authorities to ensure there is sufficient childcare available to all parents, particularly parents in disadvantaged areas. Local authorities are also required to secure places for all three- to four-year-olds whose parents wish to take up a place for their child.</p>
Service characteristics	<p>Parents choose a local provider and the entitlement is free at the point of delivery. Parents can pay for additional hours. Not all parents take up the full entitlement, and some may select a provider because of its proximity or convenience, as much as the quality of its provision. Local providers can include state schools ('maintained' and academies), and private, voluntary and independent ('non-maintained') providers. In 2013, 37,430 providers were delivering the entitlement.</p> <p>The Department commissioned a childcare market providers finance survey in 2012, which found that:</p> <ul style="list-style-type: none"> ● most providers have spare capacity, which suggests competition between providers would tend to push fee levels down; ● around a quarter of providers had made a loss; the majority had made a profit or broken even; and ● the scale of provision affects profitability (providers with large settings were more likely to profit than small settings), as does the type of care offered (full-day care was seen as being the care type most likely to generate profits).
Market characteristics	<ul style="list-style-type: none"> ● The top twenty nursery chains have an estimated 10 per cent of the market. The largest provider holds less than a 2 per cent share of the market. ● The nursery market is highly fragmented and is dominated by a large number of standalone 'for-profit' providers serving a local population, as well as a significant number of 'not-for-profit' third-sector providers, nursery classes in maintained schools and a small number of maintained nursery schools. ● Occupancy rates in the sector are estimated at around 80 per cent, (but this hides considerable variation, a quarter of all nurseries reported no vacancies); in addition occupancy of nurseries typically varies throughout the year.¹ Overall this implies there remains spare capacity.

Figure 5 *continued*

Early education and childcare sector

Public and private market shares

Government spending on the early years entitlement represents about 54 per cent of the early years nurseries market. The ratio of private hours to publicly funded hours varies from area to area, and from childcare setting to setting.

Regional market variation

The median early years hourly rate for private, voluntary and independent providers in England is £3.83. However, hourly rates vary from local authority to authority. For example, in Bromley, an outer London authority, the rate is £4.49 per hour, whereas in Sunderland the rate is £2.37 per hour. The Department's benchmarking tool enables each authority (as well as parents and providers) to compare their rates with ten 'statistical neighbours'.

Occupancy rates also vary significantly: the highest average occupancy rates (83 to 84 per cent) are found in parts of the south and Yorkshire, while lower occupancy rates are found in the north-east and the south-west.

Note

1 Laing & Buisson, *Children's Nurseries UK Market Report*, 2011, pp. 22–3.

Source: National Audit Office

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

1.9 With the shift away from state provision of services, the government is typically a major buyer in public services markets. However, there is a spectrum of market provision in public services provision (**Figure 6**). Government (local authorities for example) buying power can be dominant in their local markets for public services. At one extreme, the government may be the sole purchaser (a monopsonistic position), which influences the prices charged by providers in the market. Such a dominant position in a market can potentially cause serious problems. For example, a local authority (knowingly or unwittingly) exerts its substantial buyer power to depress prices below competitive levels, and forces providers to accept unsustainable prices. This can severely limit market supply if new providers are not attracted to enter the market. In the worst case, it could even dry up supply by driving providers out of business, or exit the market for more profitable business elsewhere. At the other extreme, the government might face a monopolistic provider of services. For example, the privatised regional water companies and parts of the rail, telecoms and energy industries.

Figure 6

Spectrum of public services provision

Balance of market power (many sellers, many buyers)	Asymmetry of market power (few sellers, or few buyers)
VFM achieved by adhering to principles for effective competition; pricing techniques less 'prescriptive': benchmarking, framework contracts can have a role etc.	VFM requires more active intervention, and/or creating a more balanced market: awareness-raising by competition authorities; pricing techniques more 'prescriptive': costing models, honest brokers etc.

Source: National Audit Office

1.10 There are various regulators to guard against problems associated with high degrees of buyer or seller power in markets. Principally, the Office of Fair Trading (OFT) oversees private and public markets.¹³ Its powers include undertaking market studies where problems are apparent, enforcing competition law and reviewing relevant mergers. The OFT has studied public and private markets (for example the care homes market in 2005, the dentistry market in 2012). There are also economic regulators who determine the price limits that utilities companies may charge customers for their services. The government has also recently established a sector regulator (Monitor) for NHS-funded healthcare who, along with the OFT, has competition powers that cover the NHS-funded healthcare markets.¹⁴

1.11 Applying competition law to public markets is complex and largely untested; its provisions do not always capture public authorities unless certain conditions are met.¹⁵ In private markets, a firm with substantial buyer power, or monopsonistic power, which exploits its dominance to bear down on providers or producers could have competition law enforced against it for abusing its position. It is less clear whether this is the case if government (such as a local authority) behaves in a similar way. The OFT may instead consider advocacy work, or opening a market study to explore competition issues in that market (and, where necessary, referring it for more detailed investigation).

1.12 It is therefore important for government departments to work with the competition authorities. Together, they should raise awareness of the conditions under which competition rules could apply to local authorities' involvement in public services markets, and what behaviours and practices are best avoided. In addition, the government should also monitor the outcomes of relevant judicial reviews. These can help to highlight legal points and establish case law that should inform future conduct; particularly in determining fair costs, and price negotiations, for public authorities and providers.¹⁶

Part Two

Local market oversight

2.1 This part looks at how local authorities should understand the characteristics of their local public services markets, their position in them, their role in sustaining them, and the need to avoid procurement strategies that may leave gaps in provision, and longer-term supply problems.

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

Local authorities longer-term view of provision

2.2 The government recognises that local authorities should take a longer-term view of local provision. Local authorities have a statutory responsibility to ensure there is sufficient childcare available to all parents, particularly in disadvantaged areas (Childcare Act 2006). The local authorities we visited knew the provider market, where performance problems exist, and areas where providers might need help to sustain provision.

2.3 The government's Care Bill delivers the white paper commitments to introduce a duty upon local authorities to promote diversity and quality of care services.¹⁷ Most local authorities, following guidance from the Department of Health (the Department), have now developed market position statements setting out how they will achieve these aims, and generally oversee the health of their local care market. The government's wider reforms to public procurement urge those purchasing care and support to seek value for money over the long term, consider the sustainability of supply chains, build capability and support small and medium providers.¹⁸ To support this process the Department funded a national programme for local authorities supported by the Association of Directors of Adult Social Services and a range of provider bodies.¹⁹

Local authorities intervene to secure provision

2.4 Most local authorities have to deal with the issue of ensuring sufficient provision in sparsely populated rural areas. Travel time and the associated cost can make home care visits relatively high cost. Local authorities we met addressed the potential risk of gaps in care provision by, for example, commissioning with providers that cover the whole of the authority's area including outlying areas. Local authorities we interviewed that had outlying rural areas monitored the financial health of the provider(s) in these areas. If the provider looked likely to exit, the authority increased their volume of work to help sustain their financial viability. Alternatively, the local authority would incentivise well-performing providers to extend their coverage or encourage new providers to enter the market in those areas.

2.5 In providing early years nursery childcare in deprived areas there is a greater likelihood of providers operating at a loss, or childcare being judged by Ofsted below 'good', than in the least deprived areas.²⁰ In deprived and sparsely populated areas local authorities have found it difficult to interest new providers in entering the local market. Authorities said that they are prepared to intervene in the market to prevent provider failure and help achieve their policy objectives by supporting sole providers during demographic dips in numbers; or to help them improve their quality where they are rated as substandard. Some local authorities also provided discretionary 'sufficiency payments' for early years providers, to keep smaller providers running in outlying areas where their collapse would effectively curtail local provision for parents in surrounding areas.

Local authorities act to improve value for money

2.6 Our interviews with local authorities identified a number of different approaches to purchasing care, which achieved value for money. These are set out in **Figure 7** overleaf and may read across to other public services markets.

Commissioning for other buyers

2.7 Some local authorities take a broader view of the local market and take into account wider public sector requirements, in particular local NHS trusts, for example for residential placements. We found some trusts use the local residential nursing home market to procure places for patients as a lower cost alternative to an acute bed in a long-term ward. Some local authorities we met have agreements with local NHS commissioners that the local authority will contract for residential places for them. This could have the benefit of increasing the local authority's buying power in the local market and may achieve better prices for residential placements than otherwise would be possible. It also avoids the two public sector buyers competing against each other in the same market. In some local areas, commissioners have made effective joint arrangements (in one case such an arrangement had been in place for several years). These type of arrangements are not universal across the country.

Figure 7

Care purchasing strategies that secure value for money

Exploiting their geographical proximity to lower-cost areas: we found that local authorities may place users requiring a residential placement into a care home of acceptable quality in a neighbouring authority, if the 'going rate' was significantly cheaper. This practice is common in inner and outer London where the care home bed rates vary significantly.¹ One London borough we visited used out-of-borough placements to place users either in neighbouring London authorities or in parts of the neighbouring county close to the authority border. The rates there were significantly cheaper than the 'going rate' for beds in their own authority.

Exploiting geographical coverage of the 'market': we found framework contracts used in social care that do not guarantee home care providers a fixed number of hours. Instead they allow the authority to place work with a number of accredited providers and use the competitive process between providers to bid down costs. The local authority awards work to the firms offering the best cost-quality characteristics, who get first refusal on the work. These contracts also allow flexibility as they let the authority build into home care contract prices the capacity to include coverage of outlying and sparsely populated rural areas. In these areas the cost of provision for individual users, due to the travel time involved, would typically be uneconomical if not included in the area-wide contract. It also allows the authority to help the sole care provider that covers an outlying area, to cope with financial viability issues that risk it exiting the market. The authority can adjust contract volumes to help support the provider at risk over its period of financial viability. In the short term, this helps the authority to avoid having to make expensive arrangements to ensure service continuity for users if the provider exits the market.

Note

¹ Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 228.

Source: National Audit Office fieldwork visits

2.8 Our findings on how local authorities can understand their impact on local markets suggest the following poor practices to avoid and good practices to adopt.

Good practice tips

	Poor practice	Good practice
Sustainability	<p>Authorities do not appreciate the importance of longer-term sustainability of the local market. A local authority puts 'all their eggs in one basket' with a large provider who undercuts all other local providers. The provider gets into financial difficulties and exits the market. This leaves the local authority vulnerable, and lacking a local provider base that can provide services.</p>	<p>The local authority develops a local market strategy to purchase public services. The strategy is designed to achieve value for money over the longer term, by building the local supply chain and its sustainability, growing local provider capability and encouraging new entrants in the local area.</p>
Intelligent buying	<p>The local authority and local NHS contract separately for residential nursing care, and miss opportunities to combine their buying power.</p>	<p>The local authority and local NHS develop a constructive relationship and work together to negotiate good value contracts with local residential nursing care providers. They do not allow local providers to play one off against the other.</p>

Part Three

Striking the right price

3.1 This part examines local authorities' efforts to understand the costs of service provision and thereby pay a price that achieves value for money. There are many factors that can affect price, including awareness of benchmark costs and the degree of cross-subsidisation by providers with income from private customers. It is therefore difficult for a local authority to establish precisely a price that allows it to provide statutory service levels and maintain value for money. This part shows that:

- an authority must understand the costs of provision, including the various elements that make up the costs, for the different types of provider in the market; and
- the authority will need to understand how to sustain provision, in the short and longer terms.

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

3.2 To meet their statutory duties in providing care²¹ and early years entitlements,²² local authorities need to pay a rate that sustains supply in the short and long term. However, providers' standard rates may not be a good guide to service costs, and are more likely to reflect customers' willingness to pay. Achieving value for money therefore involves understanding the true costs of provision for the different types of provider. We found authorities using different methods to determine or estimate the costs of provision depending on the degree of competition in the market (**Figure 8** overleaf).

Different elements of service costs

3.3 Staff costs are by far the largest cost in home care and in care homes, typically accounting for between 49 and 57 per cent of total costs (the higher end costs reflect nursing care for older frail and dementia sufferers).²³ Staff costs account for a much higher proportion of a provider's total costs in home care delivery where the care is provided in the user's own home. The situation is similar in providing the early years entitlement, where staff costs make up 77 per cent of the total, on average²⁴ (**Figure 9** overleaf).

Figure 8

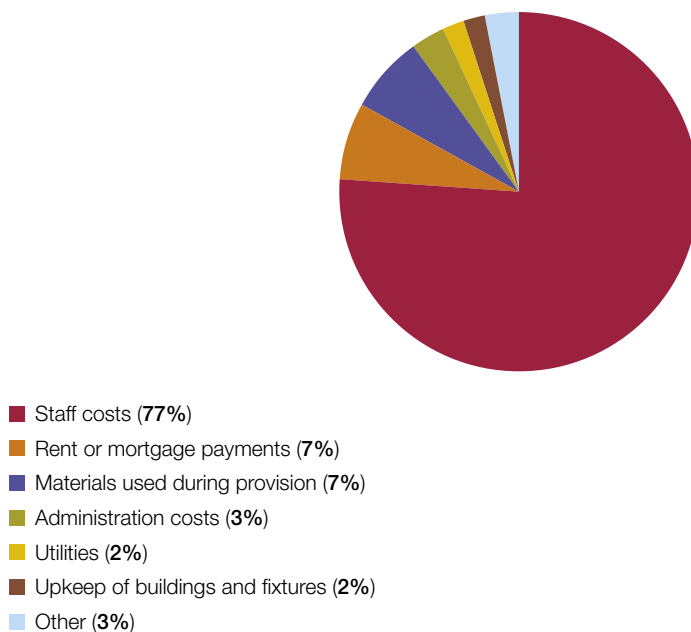
Methods of increasing value for money when setting rates for services, in different market structures

	Balance of market power (many sellers, many buyers)		Asymmetry of market power (few sellers, or few buyers)	
Methods of increasing VFM	Framework contracting	Benchmarking	Open book/honest broker	Costing models
Illustrative example of service type	Commissioned basic needs home care	Early years education provision	Residential placements	Specialist care for complex needs

Source: National Audit Office

Figure 9

Breakdown of group-based childcare provider costs



Note

1 Percentages may not sum to exactly 100 per cent due to rounding.

Source: National Audit Office analysis of Department for Education Research (see endnote 24)

3.4 There are wide geographical variations in staff costs. For example, costs in affluent areas tend to be higher, as providers compete for staff with a large number of other employers. In childcare there can be cost variations between ‘maintained’ and other settings because of separate requirements for ‘maintained’ providers to have teachers. Average pay rates for qualified staff are at least 28 per cent higher than those for unqualified staff.²⁵ And maintained nursery schools have additional costs, such as having a head teacher.

3.5 The make-up of non-staff costs can vary widely between providers and will reflect how the provider chooses to run their business as well as other external factors. For example, the cost of a residential care home will reflect the financial structure of the provider and the mix of mortgages, loans, and leases as well as the imputed cost of the proprietor’s own capital.²⁶ Similarly, in childcare, different settings will have different costs owing to differences in business model and tax treatment.

Models to understand costs and negotiate fair prices

Care homes

3.6 Some local authorities have developed models to understand costs and negotiate fair prices with providers. The Department of Health leaves care home pricing to individual authorities. However, some providers are concerned that local authorities’ payments for care home beds for older people do not reflect the true cost of care and that there can be ‘cross-subsidy’ from care funded privately.

3.7 Providers have launched a number of judicial reviews recently, with some successful reviews leading to significant increases in the cost of residential placements. For example, the highest increases were in Wales “driven in large part by the judicial review of Pembrokeshire’s fee setting process which led to the threat of similar action being taken by care home operators in other areas of Wales”.²⁷

3.8 At the end of 2011 a working group of representatives of providers and costing experts from Laing & Buisson joined the Association of Directors of Adult Social Services and a local authority sponsored social enterprise, the Improvement and Efficiency Social Enterprise (iESE), to consider how to improve cost transparency and overall value for money. They found it difficult to agree on a model that suited all parties because of differences in types of provider, market variation and other varying local circumstances. However, they agreed on a set of principles to enhance transparency, which provide a useful framework for providers and commissioners (**Figure 10** overleaf).

Figure 10

Care cost model principles developed by the working group of representatives

Care and accommodation costs will be separated out.

Costs will be based on a set of (reasonable) assumptions which will be clearly defined.

In each local area or each contract negotiation there will be a need to take into account a range of factors and to consider the appropriateness of assumptions in the area or for the service under discussion.

Local market conditions in terms of supply and demand will have a legitimate impact on price.

There may be circumstances where the value of high volumes of business from a commissioner warrants a discounted price.

No model can reflect nor should attempt to reflect the full range of provider operating models or local circumstances.

The cost matrix is intended to provide a transparent starting point for providers, commissioners and potentially, self-funders.

Source: Working group of representatives of social care providers and costing experts

3.9 At our meetings with local authorities and provider associations, the most contentious element of costing models was the 'return on capital' allowed for the provider. However, most stakeholders we interviewed considered that a costing model should not provide a prescriptive answer on price, or indeed return on capital, but instead should support transparent local negotiation by being flexible.

3.10 Also, some authorities were improving cost transparency through an 'open book' approach with a third party acting as an 'honest broker'. The honest broker surveys, anonymises and analyses the cost data from providers and arrives at a reasonable cost (based on weighted averages, and removing statistical outliers). Authorities had made significant savings from using this approach (**Figure 11**). In particular using a third party can help to build trust and mitigate the risk of poor survey response rates that can undermine the exercise.

3.11 In another case, a large, mainly rural, local authority developed a cost model for care provision in their area based on a cost survey. An external third party validated the model, and queried anomalies and outliers, as well as helping to negotiate the level of return on capital using external benchmarks customised to the local area. Several other similar neighbouring authorities have adopted the model since.

Residential and supported living placements for adults with disabilities

3.12 Some local authorities have worked with the iESE to develop a costing negotiation tool called the Care Funding Calculator (CFC), for younger adults. This was in response to concerns over high prices for care packages for people with the highest levels of need. The tool helps purchasers and providers benchmark the level and cost of staff support appropriate for meeting an individual's accommodation-based care needs. The CFC does not give an exact or 'right' price but gives a guide range based on market research as to what is a reasonable price for a service of that size in that area.

Figure 11**Case study – the ‘open book’ approach with a third party acting as ‘honest broker’**

The authority had been paying different rates for older people’s care home beds to providers in the city. They worked with the sector to decide the costs of a care home place. They commissioned a third party (a leading audit firm) with experience of running care homes, to act as ‘honest broker’ and formed a provider representative group, which included large and small care operators. The honest broker did not identify individual providers or disclose cost data to the local authority except in anonymised form. The broker achieved a response rate of 47 per cent from local providers.

The cost analysis found a high level of consistency in the fixed and indirect costs between the different providers, but a significant inconsistency in the level of providers’ capital costs. Out of 93 local providers, they found 60 different models of capitalisation, which reflects the many different types of business model in this market. In its data analysis, the honest broker used weighted averages and excluded statistical outliers to estimate the true costs of provision. The weighted average builds in the effects of economies of scale on costs, which helps to incentivise less efficient providers to improve their efficiency. The third party negotiated with a small group of provider representatives of large and small care operators, and arrived at an agreed rate of return on capital. The authority did this four years ago. Since then, it estimates that it has made ‘cashable’ savings of £3 million from reductions in the fees they had been paying, and a further £2.5 million in ‘non-cashable’ savings on placements for new users.

Source: National Audit Office

3.13 Authorities we interviewed had successfully used the CFC (or similar tools) to renegotiate long-term care packages where a reassessment of the user’s needs was due. The process appears to work best where finance or specialist contract staff work alongside social workers during a reassessment. We interviewed one local authority, for example, which had made an estimated annual saving of £100,000 on the care packages of three people, and made total annual savings of £750,000 by using the tool. The iESE is currently creating an online prototype, which is intended to go live in April 2014. This will mean that authorities update the CFC with actual cost data as they use it, and further strengthen the currency of the data.

3.14 A few authorities we contacted had faced reluctance from providers of expensive specialist care packages to renegotiate using the CFC. This was despite reassessing a user’s needs being a routine requirement. One authority had dealt with this situation by giving the provider a year’s notice of termination, and threatening to move the user to another provider (following reassessment).

Home care

3.15 The UK Home Care Association has also developed its own web-based costing model for home care. It is a non-prescriptive model and includes an exhaustive list of cost items based on relevant regulations such as the national minimum wage. The Association is currently seeking endorsement of the model from the Association of Directors of Adult Social Services. For social care users with a direct payment, common methods used to set an hourly rate for personal care included using the hourly commissioned rate for an agency care worker (less central overheads), or hourly rates advertised locally. In one authority, however, a local provider of agency staff was charging direct payment users the same rate as a private client rather than the lower hourly commissioned rate.

Early years entitlement

Cost models

3.16 In its guidance for Early Years Single Funding Formula,²⁸ the former Department for Children, Schools and Families said that local authorities should improve their understanding of provider costs through surveying providers and building a typical cost model. Our 2012 report found that 97 per cent of local authorities had conducted surveys but one third did not find the results useful.²⁹ Interviews with local authorities uncovered a range of reasons for this, including:

- a suspicion that some providers were overstating actual costs;
- providers being unable to provide robust estimates of their costs;
- high variance in reported cost for certain items (such as accommodation); and
- misunderstanding over which costs are eligible (such as profit).

A number of local authorities have, however, constructed cost models estimating staff costs from regulatory requirements for qualified staff, staff-to-child ratios and reference pay scales.

Benchmarking

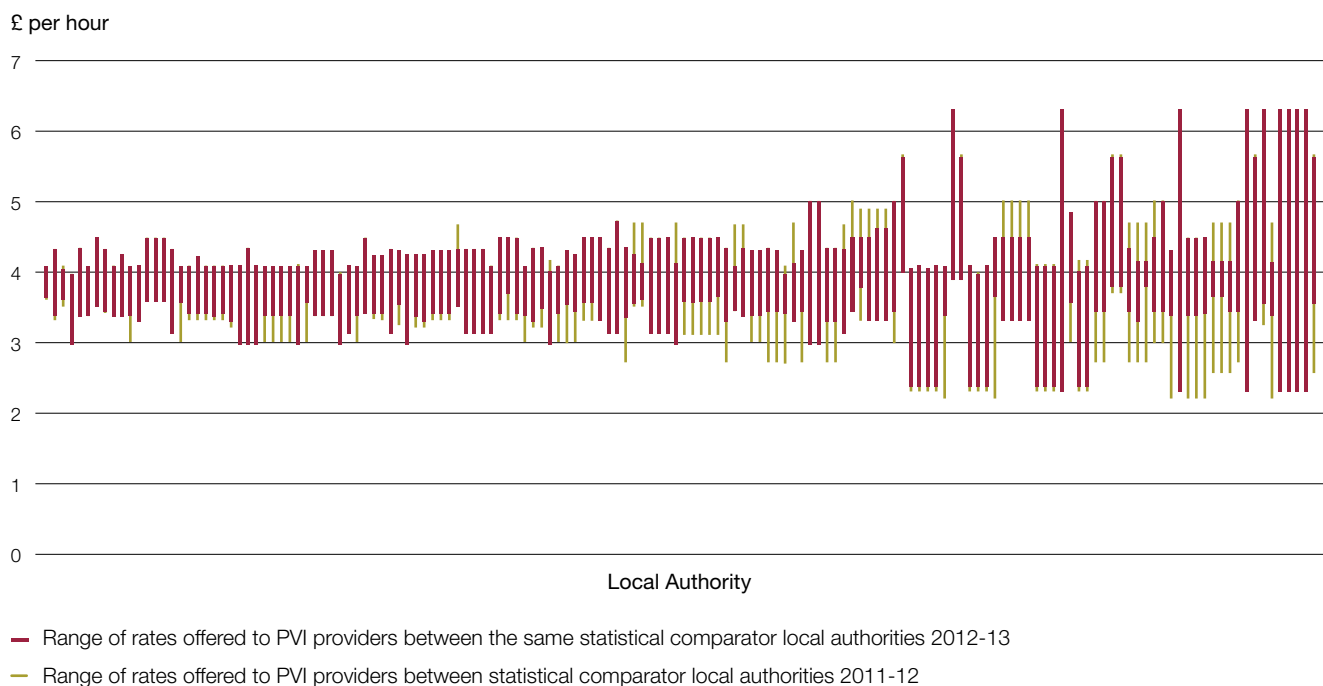
3.17 Our 2012 report on the free childcare entitlement found that local authorities needed to improve ways to benchmark and compare performance. From a survey of local authorities, 89 per cent had compared their base rates, however 57 per cent had not compared beyond their own region. They were much less likely to have compared costs of settings, take-up, or levels of workforce qualification in the sector.

3.18 In 2011, the Department for Education (the Department) developed and set up a benchmarking tool. The tool allows local authorities to compare their spending on providing the free entitlement with up to ten statistically similar comparators, based on local authorities' submissions setting out intended spending in their local areas.³⁰

3.19 We analysed local authority spending on the free entitlement using the Department's benchmarking tool. Our analysis showed some evidence of convergence in the range of rates that local authorities offered to private, voluntary and independent (P,V, I) providers between the years 2011-12 and 2012-13 by statistical comparator authorities (**Figure 12**). It is also consistent with the possibility that local authorities are using the benchmarking tool to ensure that they are more in line with rates paid by their comparators.

Figure 12

Convergence in rates offered by comparator local authorities

**Note**

1 Comparators are defined as local authorities which have similar demographic characteristics.

Source: National Audit Office analysis of the Department's Local Authority benchmarking tool for 2011-12 and 2012-13

3.20 The Department's benchmarking tool could, however, be improved to better serve the needs of local authorities, providers and parents. From our interviews, some reasons cited for not making fuller use of the tool included the following:

- The rates returned by the calculator may include the base rate and not the supplements; or if they include supplements there is no information on how many providers receive which supplement.
- The rates returned by the calculator have until recently been based on averages created using projections of childcare hours and funding in each category of provider. These do not necessarily reflect the actual rates that local authorities pay to providers in each category. However, the Department is revising the benchmarking tool to incorporate evidence on how many hours are claimed at the actual rates offered by local authorities. This will allow more informed comparisons to be made between the rates which different authorities offer.

Good practice tips

		Poor practice	Good practice
Building cost models	Transparency	Costing models, with little market scrutiny. These lack transparency as to what costs are included, and become outdated easily.	Costing models that are transparent, flexible, can be updated, and which are shared with other similar authorities for mutual benefit.
	Flexibility	Hard-coding of inflexible assumptions on contentious areas (for example return on capital) into costing models.	Costing models that are non-prescriptive, flexible and thereby aid price negotiations.
	Sense checking	Lack of sense checking of cost data. For example, without understanding the true costs, hypothetically collusion or bid-rigging by providers could go undetected.	Major cost elements are identified and fully costed (staff costs and accommodation). Key drivers of cost, such as the ratio of privately funded to local authority funded users are identified and modelled.
	Consensus	No involvement of a third party or provider representatives in the local authority's surveys of providers' costs. This can result in a lack of buy-in or mistrust in the results.	Consider use of 'open book' approach and engage a third party as 'honest broker' to encourage provider engagement.
Applying cost models		Individual users on high-cost legacy care packages are rarely or never reassessed, nor contracts renegotiated effectively, which creates poor VFM and excessive profits for the provider. Social work, finance and health professionals work separately on user cases and do not holistically assess the individual's care needs and reach cost-effective solutions.	At the point of reassessing a user's individual needs, especially where these are complex, social work (and where relevant healthcare) and commissioning and finance professionals work together to assess the individual's needs in developing an individual package of care and support. Where a provider refuses to engage in reassessing a user's care needs, the local authority may need to consider removing the provider from the authority's approved list (and making this known to neighbouring authorities).
	Fragmentation of buying power	The greater take-up of direct payments leads to more fragmentation of demand. Providers charge higher rates to direct payment users for agency care staff, leading to increased costs for the local authority's social care budget.	To counteract the fragmentation of the demand-side of the market, local authorities find effective ways to leverage the value of direct payment users' business, without undermining the individual user's expectation of opting for the care package that meets their needs. In addition, local authorities can help develop direct payments users' skills and competencies in negotiating a care package that achieves their care needs and desired outcomes within available budgets.

Principle six: The price sustains supply at acceptable levels

3.21 Local authorities need to understand the fair costs of provision locally and not rely on cross-subsidisation (by private payers) as this may create poor long-term supply sustainability. Local authorities need to balance between using buyer power to achieve competitive prices for care, and ensuring sufficient provision so providers make adequate overall returns and do not exit the local market.

Ensuring sufficient provision

3.22 Local authorities must ensure that there is sufficient local provision. They must balance using their buyer power to achieve a more competitive price, against the risk that using this strategy too rigidly will mean providers will pursue one (or more) of the options below. These could leave the local authority unable to meet the needs of users:

- Reduce staffing levels below adequate levels, which has a detrimental impact on service quality.
- Increase the ratio of private users (or even decide to no longer take local authority funded users).
- Increase the fees of private users to cross-subsidise the local authority funded users.³¹
- Exit the local market.

Expectations for profit margins

3.23 Expectations for profit margins vary considerably and can significantly influence supply. Value for money is most likely to be achieved when demand and supply are roughly in balance. Too much capacity can lead to fee rates (and profit margins) dropping to unsustainably low levels while too little can result in increased fees. The main area of contention in price negotiations is therefore likely to be the profit margin. This fact increases the importance of local authorities understanding the true costs of provision and benchmarking profit levels with other authorities to ensure the profit levels are aligned with those in the sector.

3.24 We found that expectations of profit margins in the care sector varied considerably. In home care, the main provider association indicated that large-scale providers work to relatively low margins (in the range of 2 to 3 per cent on local authority commissioned contracts). At a national workshop run by the Association of Directors of Adult Social Services, we found that mainstream care profit margins of around 5 to 7 per cent were considered by participants to be typical for the sector. However, the Laing & Buisson costing toolkit considers a profit mark-up of 10 to 15 per cent as necessary to reflect the risks of investing in the care home sector.³² In more specialist areas, such as care for adults with learning disabilities and people with complex needs, profit levels in residential settings could be much higher.

3.25 In the care home sector, the English Community Care Association indicated that providers' profit or loss margins on local authority commissioned contracts vary significantly. And they are influenced by factors including: the level of spare capacity in the local area, and the ratio of private to publicly funded beds. They also indicated that cross-subsidisation may also occur nationally. Large care providers may use profits from their private users in the south to cross-subsidise their care home beds in parts of the north where local authority buyers are typically more dominant in local markets.

3.26 The Department's guidance for local authorities requires them to allow providers to earn a surplus either for a return on investment or for future investment. The local authorities we visited had allowed for a wide range of profit margins between 0 and 15 per cent.

Cross-subsidisation and private and public service markets

3.27 Cross-subsidisation can be a typical feature of private and public service markets. However, there are risks to provision if local authorities rely too heavily on providers being able to cross-subsidise publicly funded services. Cross-subsidisation occurs in some public service markets where providers charge higher fee rates to private users, which help to subsidise lower rates paid by local authorities. Local authorities we met noted the benefit to providers of public services having another source of income, for them to increase their financial viability.

3.28 In social care, we interviewed large care provider associations. Providers that do not have mixed provision (that is, a mix of private and publicly funded users) and rely solely on local authority funded contracts will struggle to make a profit. In addition, a judicial review into care home fees in 2012 found that the local authority had acted rationally in setting fee rates for publicly funded residents, which were cross-subsidised by private payers.³³ This suggests that local authorities may not be acting unlawfully in considering the private-payer share of the local market when they set their fee rates. Sectoral market specialists advise care home operators with high exposure to local authority funding to respond to baseline care home fees that fail to keep pace with inflation by making efficiency savings. And, where scope exists, by rebalancing their business to take on a higher ratio of private-user clients.³⁴ The scope to diversify is more constrained in some parts of the UK. For example, in parts of the north there is relatively low demand for private care services, and providers may rely largely on provision of publicly funded services.

3.29 In early years childcare, the mean national average hourly funding rate for three- and four-year-olds of £4.21 (and £5.25 for two-year-olds) compares to the average price that providers are charging for provision for two-, three- and four-year-olds of £4.26.³⁵ This is according to the Family and Childcare Trust's annual childcare costs survey.³⁶ There also appears to be more providers wishing to enter the market. In 2013, figures suggest 540 more providers chose to offer the free entitlement for three- and four-year-olds than did so in 2012.³⁷ Local authorities also said that there are few providers who withdraw from offering the free entitlement in their areas.

3.30 The Family and Childcare Trust's childcare costs report recognised that their survey did not examine what providers estimate their services actually cost. In their experience, this was likely to be a different amount from the price because of complex systems of cross-subsidy and the array of business models that different providers use.³⁸ This is illustrated in a case study of a national private nursery chain whose business model uses private hours to balance its early years provision (**Figure 13** overleaf). The different rates of profitability for various types of childcare provision were acknowledged in a childcare provider finances survey commissioned by the Department. The survey found that providers thought that full-day care was the most likely to generate profits (55 per cent reported this). Fewer providers considered before-school care and holiday care to be profitable. Roughly a quarter of providers reported these were likely to be loss-making. Provider associations argue that many nurseries work to break even by charging working parents a higher rate for additional hours that they purchase over and above the early years free entitlement. However, the Family and Childcare Trust's Report also recognises that cross-subsidy can work the other way. Early years providers in some areas can cross-subsidise activities that are not publicly funded, in particular childcare for babies, where higher staffing requirements can make childcare too expensive for local markets to sustain.

Cost pressures and sustainability for providers

3.31 Costs of provision are ever changing, and local authorities should understand what affects them and reflect this in their costing models. In a recent survey of nursery providers, the National Day Nurseries Association identified the five most challenging issues for their sustainability as: the increase in costs of utility bills, providing a sustainable free nursery education, increasing staff wages, controlling costs and achieving profit or surplus.³⁹ We interviewed local authority early years professionals. They indicated that in the last couple of years local authorities have been increasingly pressured to increase base rates from the private, voluntary and independent providers who employ staff on the national minimum wage (NMW). The NMW legally has to be increased by inflation. There has been less pressure from providers in maintained settings where staff are on teaching pay scales that have been frozen. Some providers expressed concerns, however, that pre-school nursery settings would lose graduate staff to schools where pay is higher with greater prospects of career and pay progression.

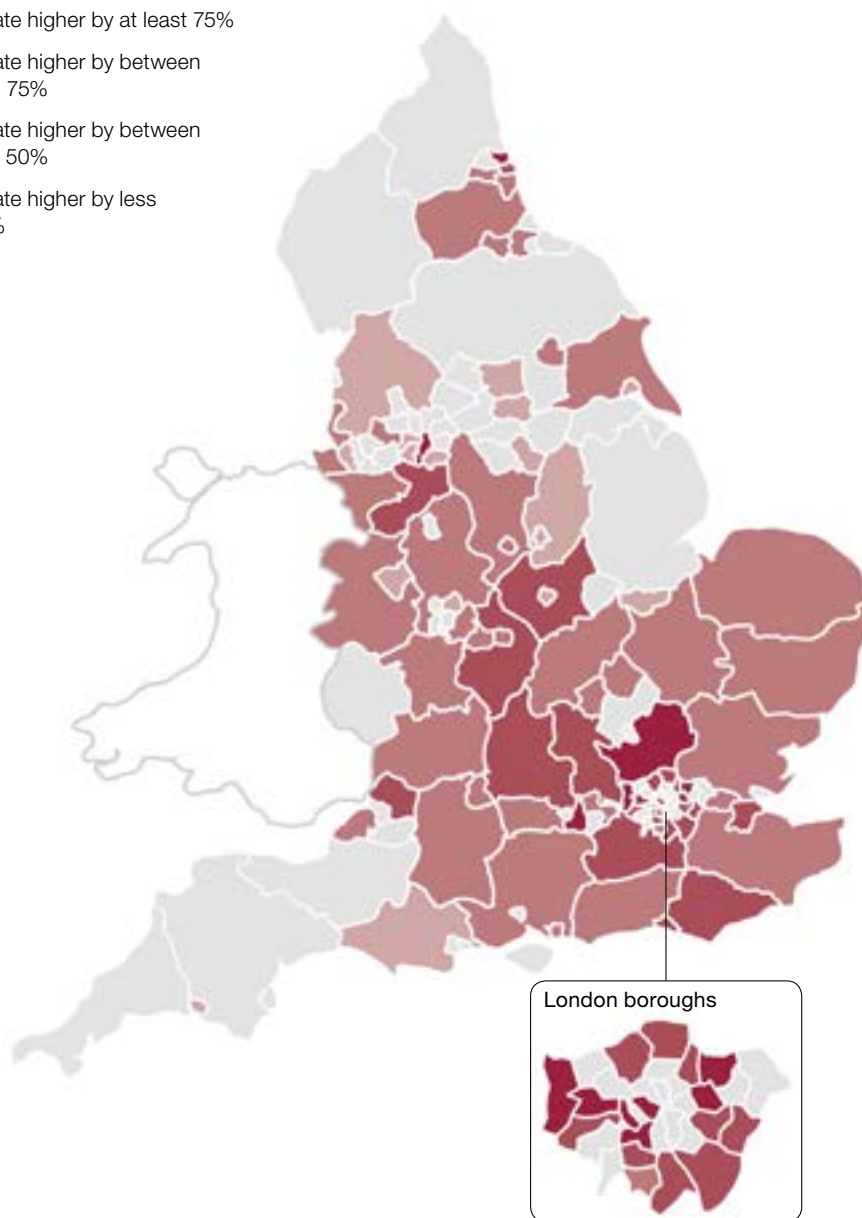
3.32 Local authorities and stakeholders also noted that in parts of London and the south-east providers have experienced high rental increases at a higher rate than inflation. In addition, in London one effect of the 2012 Olympics was to create a surge of retail and commercial activity in parts of east and north-east London. This created significant numbers of higher-paying retail jobs. One local authority said that some local care providers had faced recruitment and retention problems over a number of months as care workers left to take up higher-paid employment opportunities in the retail sector.

Figure 13

Case study of a national operator of day nurseries

A large national operator of day nurseries that is active in many local authority areas provided a breakdown to show how the shortfall between the costs of provision and early years rates could vary significantly between areas (see below). This shows that selling private hours at a higher rate is a key component of their business model. The lowest percentage shortfalls were found in the north, while the highest in the south-east and some urban areas.

- Private rate higher by at least 75%
- Private rate higher by between 50% and 75%
- Private rate higher by between 25% and 50%
- Private rate higher by less than 25%
- No data



Source: National Audit Office analysis

Credit checks to assess providers' financial viability

3.33 Some local authorities do credit checks to assess providers' financial viability. In recent years, the social care and the early years nursery sectors have seen a few large-scale publicly listed companies that had expanded rapidly, exit the market because of unsustainable business models. Some local authorities we interviewed did routine credit checks on providers from whom they commissioned significant levels of public services. This gave authorities assurance on providers' continuing financial viability and information on the sustainability of local public services.

3.34 In addition, in response to the collapse of Southern Cross (the UK's largest provider of care homes until its demise in 2011) the Department of Health developed a proposal to monitor the financial viability of 'hard to replace' care providers. The Care Bill provides for a new financial oversight regime to be operated by the Care Quality Commission from April 2015 to improve the central oversight of the major providers operating nationally and regionally, and which are beyond the scope of individual local authorities to monitor.⁴⁰

Local authorities' awareness of competition law

3.35 Competition law governs competition in commercial markets and has two main prohibitions. First, collusion or cartel activity that leads to fixing or distorting prices and, second, abusing a dominant position. As noted earlier, local authorities can be the main or the most dominant purchaser in their area if there are limited other sources of demand. In these circumstances, their position could in principle be described as one with a high degree of buyer power (moving towards monopsony) over the local market. This gives local authorities a strong bargaining position in negotiations with providers. It may allow them to put excessive pressure on the provider to keep prices level or even to reduce them, forcing the provider to absorb all the cost increases.

3.36 Applying competition law is complex and local authorities may not necessarily come under its provisions.⁴¹ However, local authorities need to act with care. Courts may still judge that they have acted unfairly, even if their actions are not directly caught by the prohibition against abusing a dominant market position. For example, in a court case in 2012 a group of local care providers challenged the local authority's decision to offer no increase in fees and took it for judicial review.⁴² The judge quashed the local authority's decision on several counts including on the grounds that the judge considered that the authority was abusing its dominant position in the market to drive down fees in the way criticised in a Department of Health Agreement from 2001.⁴³ This suggests that local authorities need to be aware that judges will consider departmental guidance on commissioning that they see as relevant in such cases.

Good practice tips

	Poor practice	Good practice
Local costs information	The local authority fails to recognise genuine cost pressures that providers face in local and national markets.	The local authority builds up a detailed model of cost elements and cost drivers affecting the costs of local provision.
Market knowledge	The local authority relies too heavily on providers making higher returns from services sold to private users to cover losses on their public services contracts. Providers' price increases may decrease private demand for their services especially during a recession, which may intensify the financial difficulties facing a local provider(s).	The local authority acts as a steward of the local market. It understands the local supply-side and uses costing models or tools to understand the true costs of provision. It works with providers to get a 'fair' local rate that sustains local provision and protects coverage, if threatened by provider exit in deprived and outlying areas.
Awareness of competition rules	The local authority exerts its buyer power to put excessive pressure on provider(s) to absorb cost increases. It is possible that the provider has to respond in a way that is detrimental to long-term service provision. This practice may not necessarily be defined as anti-competitive under the Competition Act, but the local authority is still at risk of being taken to judicial review.	The local authority is aware of competition law and its implications for their behaviour in the market, and seeks to act fairly when assessing the true costs of market provision.

Part Four

Ensuring quality of services

4.1 For users to help improve quality in a public services market two conditions must be met. First, users have to be able to inform themselves about provider quality, and second, they need to be able and prepared to act on this information. However, these conditions are not easily met in many public services markets. For example, it can be difficult for users to know in advance whether the quality will fully meet their individual needs, and social care users typically are vulnerable and can be reluctant to switch provider, except as a last resort. This means that authorities need to be ready to intervene in public markets to ensure that services meet acceptable standards. This part examines:

- how authorities can ensure quality through regulatory interventions and some of the factors responsible for affecting quality; and
- the importance of users having information to help them assess the service quality of different providers.

Principle seven: Quality is acceptable

4.2 Without effective monitoring, service quality may deteriorate for users, and lead to poor value for money. Local authorities, along with national quality inspectors, should ensure that services provided in a public service market are of acceptable quality. In the case of personalised social care, services must meet individual user's assessed needs.

Independent inspection judgements

4.3 Independent inspection regimes monitor public services. In early years provision, Ofsted inspects and assesses providers' quality, and publishes their rating of the quality of the provision in each setting. The ratings range from 'outstanding' to 'inadequate'. In 2012-13 Ofsted assessed 65 per cent of providers as either 'good' or 'outstanding'. Ofsted publishes this information about provider performance on the internet, so all potential users can access it. The government introduced changes in September 2013 to require local authorities to make decisions on funding places solely based on Ofsted inspection ratings. Authorities can no longer undertake separate assessments of the quality of early years provision. Local authorities must pass on any concerns to Ofsted, which then has procedures to re-inspect providers who come to their attention.

4.4 In social care, the Care Quality Commission (CQC) registers and inspects care providers. Until 2009, the CQC's inspection regime included a published differential-style rating for the quality of each provider similar to that used by Ofsted.⁴⁴ In 2010 the CQC withdrew its system for rating providers and replaced it with a system for assessing providers against essential care standards. The revised system helps to inform users about whether the care provider is safe. However, it gives the user little information on the quality of the care beyond that. The user is unable to tell whether it is an excellent provider or one that meets little more than the bare minimum essential care standards. From 2014 the Department of Health and the CQC are introducing a new 'Ofsted-style' quality rating inspection regime for social care and healthcare providers.

4.5 Local authorities we interviewed monitor their care contracts with providers to ensure that they meet required standards and contractual obligations. Authorities instigate remedial action where necessary. Local authorities use various sources to monitor the quality of provision:

- independent inspection reports;
- service quality feedback from professionals (for example, when social workers visit care recipients);
- contract compliance visits; and
- whistleblowing by employees or users.

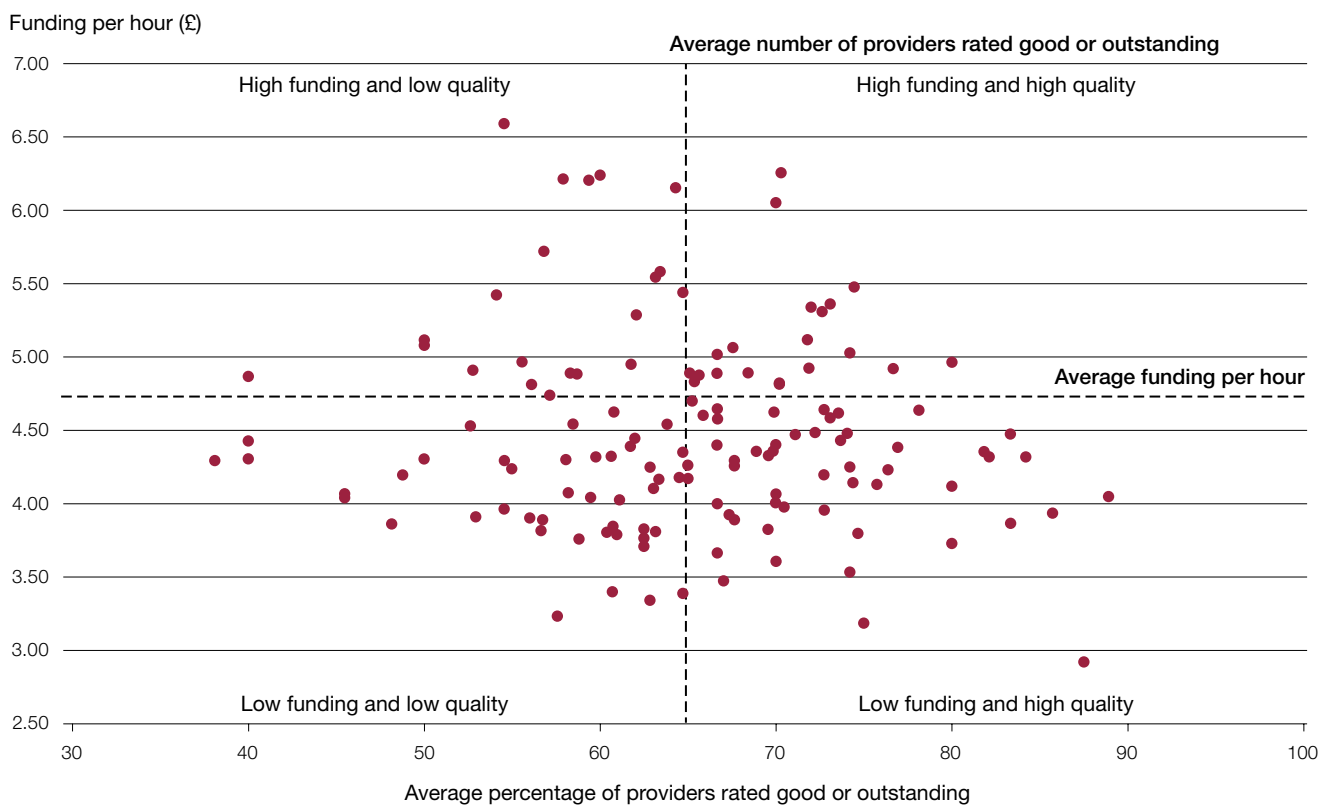
What influences provision quality

4.6 In early years provision, deprivation and the level of staff qualifications can influence the quality of provision, rather than the absolute level of funding from the local authority. It can be difficult to disentangle the multiple determinants of quality; for example our 2012 report on the early years entitlement found only a very weak correlation between funding rates and high-quality ratings. We repeated the analysis using more recent data which supported this original finding (**Figure 14**).

4.7 The local authorities we interviewed agreed that funding supplements for quality were likely to have only a limited effect on improving quality, with staff qualifications and training being much more important factors. Furthermore, a report commissioned by the Department of Education drew on evidence that the level of qualifications is a significant factor in determining the quality of childcare.⁴⁵ Our 2012 analysis also identified local factors, such as median wages and levels of deprivation correlating with quality and cost locally. Ofsted inspections have also revealed that deprivation is correlated to lower quality. For example, the proportion of non-domestic childcare settings⁴⁶ judged to be good or better was found to be 75 per cent in the least deprived regions, whereas this was only 63 per cent in the most deprived.⁴⁷

Figure 14

Funding per hour and quality of provision across local authorities

**Note**

1 Each circle represents a particular local authority.

Source: National Audit Office analysis of Section 251 funding returns from local authorities (2012-13) and Ofsted data (2011-13)

Helping early years providers 'requiring improvement'

4.8 Under current government proposals, local authorities will retain a duty to help all local providers judged by Ofsted as 'requiring improvement', to strengthen the quality of their provision. Other providers in the local authority's area may also seek advice, information and training from the local authority.

Good practice tips

Good information on quality of provision

Poor practice

The local authority has limited access to information and intelligence on the quality of provision and relies solely on periodic independent inspection reports that become outdated over time. It has a fragmented view of the local market, which impedes its ability to: ensure there is sufficient provision of acceptable quality; inform users on the quality of different providers; and to achieve value for money.

Good practice

The local authority is well informed about the quality of local providers. It monitors and maintains its knowledge and market intelligence through a variety of sources, which helps it to ensure users receive acceptable quality and to achieve value for money in its funded provision.

Principle eight: Users are well informed about quality

4.9 One of the main factors that influences the effective operation and performance improvement in a public services market, is users having accessible information on service quality. Inspection reports or ratings by quality regulators or by local authority commissioners might be sufficient in themselves, however users may be interested in other information and aspects of service quality, which regulators do not formally assess, in order to satisfy themselves before they choose a service provider.

Information on quality for public service users

4.10 Users generally have access to the independent quality inspectors' reports. These can help them assess quality. For example, the CQC's reports provide a pass or fail judgement on the quality of the provider's care. However, inspections may be infrequent, and users are likely to value aspects of quality outside those that regulators examine. For example, our 2012 report⁴⁸ on the early years entitlement found that parents commonly place a higher priority on convenience, the cost of additional hours (around 60 per cent of parents using the entitlement to buy additional hours), and their children's happiness and safety than on the Ofsted reported measures of quality.

4.11 Local authorities are developing methods to allow users to record and exchange views on quality. For example, in social care, some local authorities are piloting user customer feedback mechanisms (like a ‘Trip Advisor’ for care). Two authorities we met had plans to launch feedback portals on their websites in the next 6 to 12 months. However, local authorities using these mechanisms face various challenges, for example:

- ensuring that a sufficient number of users rate the services to produce effective ratings; and
- ensuring the currency of this information, which can quickly become outdated (relatively high staff turnover is not untypical in the care sector, rendering some user information no longer fully reliable).⁴⁹

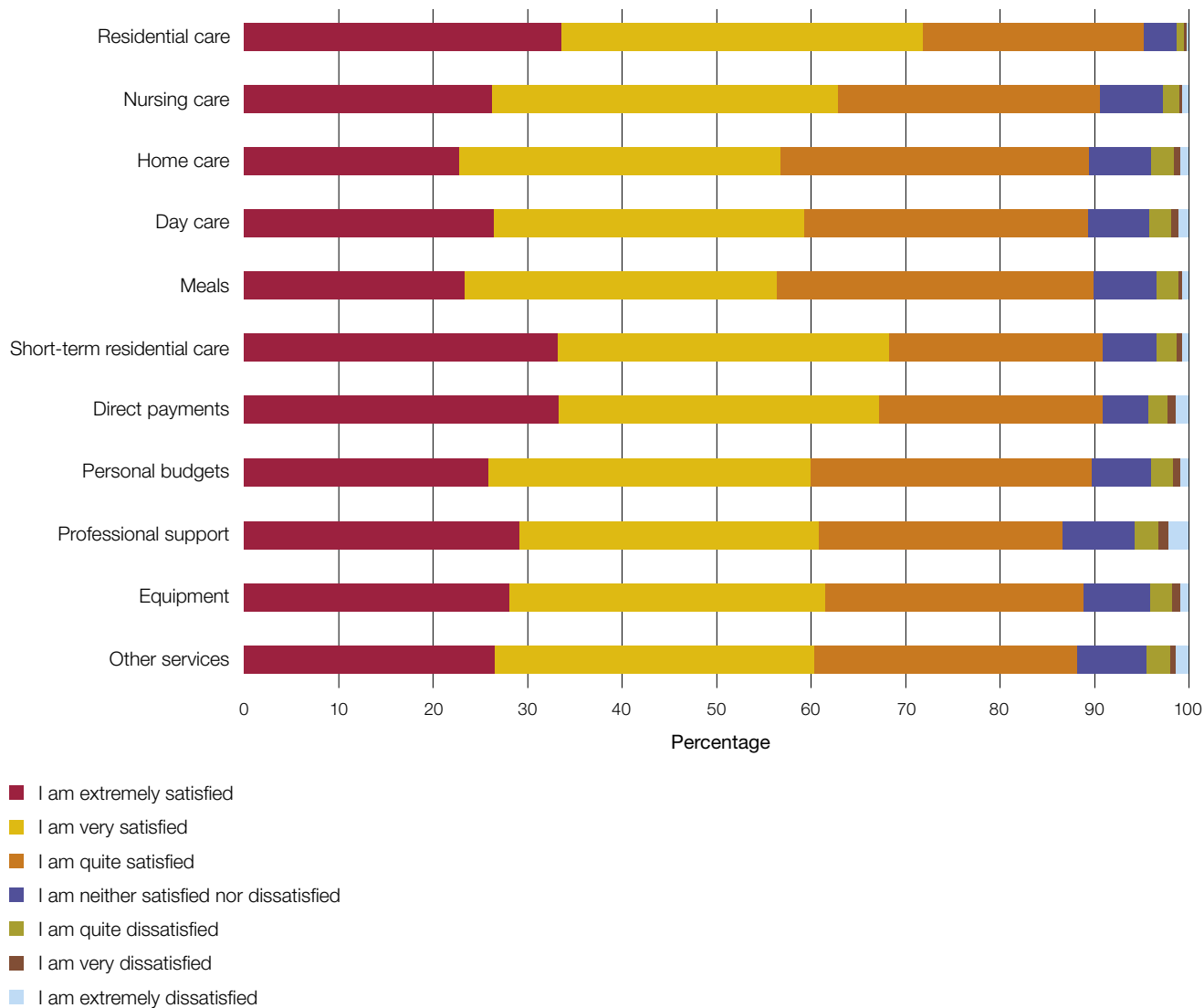
4.12 In addition, the Department of Health with NHS Choices have developed online quality profiles for CQC registered care services. Each has its own pages on the ‘NHS Choices’ website which contains service information to help people choose the right services for them. The website also allows service users to review and rate their experience of the service provider. Their feedback does not appear on the website and is treated confidentially by the CQC. From Autumn 2014, as care providers start to be awarded new CQC single quality ratings these will be added to profiles. The Institute for Government has also encouraged government in their plans to develop provider-quality profiles.

4.13 In addition to national quality regulators’ formal service assessments, and user feedback mechanisms that are starting to develop in social care, independent evaluations of personal budgets for social care have measured users’ experiences. The evaluations found that most users value being in control and achieve a greater sense of personal well-being.⁵⁰

Annual satisfaction ratings for social care

4.14 The NHS Information Centre has since 2011-12 conducted an annual survey of satisfaction rates of service users wholly or partly funded by local authorities in England.⁵¹ The national results are in **Figure 15** overleaf. Results are also available by local authority. The results indicate that residential care achieves the highest satisfaction ratings (very and extremely satisfied), while home care is among the lower-rated services. Direct payments achieve a relatively high rating, which independent evaluations have shown most users value as they are given a greater sense of choice, control and personal well-being.

Figure 15
Satisfaction of local authority funded social care users by service type



Source: National Audit Office analysis of Department of Health NHS Information Centre data 2012-13

Good practice tips

	Poor practice	Good practice
Users are poorly informed	Poor information on quality, and or poor accessibility of information reduces users' ability to make effective choices, disempowers them and weakens the influence users' have over provider income; poorly performing providers survive and users experience poor-quality services.	The local authority considers the most effective way to empower users (including private users) to make informed choices (e.g. publishing ratings, customer feedback mechanisms, provider quality profiles and so on) without destabilising the local provider market.
Access to other users' feedback	Users have no access to customer feedback. At best, users with informal networks rely on word-of-mouth, while other users have little or no feedback to help inform their decision.	The local authority recognises how independent user feedback can play an important part in informing other users and making service improvements. In line with best commercial practice, users are encouraged to give anonymous customer feedback on the quality of the provision they receive (moderated where necessary). Outliers are removed, providers are allowed to respond, and reviews are sorted by date order.
Private users' information needs	In social care, the local authority largely ignores the needs of the private users in their local area who cannot access good information on care and, as a result, make poor and expensive choices. In the longer term, private users exhaust their funds and have to fall back on the local authority funding their assessed care needs.	The local authority helps to develop the demand-side in the local market to improve awareness and information on providers and services. Helping to harness the demand-side stimulates and incentivises constructive responses from providers offering new and improved services and helps to create a more dynamic local market.
Handling complaints	Users either do not know how to complain effectively, or their complaints are not dealt with effectively.	In the first instance, users should complain to the service provider. If the provider fails to respond effectively, the local authority deals rapidly and effectively to address user complaints.

Endnotes

1 This report examines pricing mechanisms for two of the main types of social care (residential placements and home care). It does not specifically look at some other types of care services, such as those classed as ‘community services’. However, the principles outlined in the report can also be applied to these other services, in particular the need for reference prices.

2 National Audit Office, *Delivering public services through markets: principles for achieving value for money*, June 2012.

3 Comptroller and Auditor General, *Department for Education, Delivering the free entitlement to education for three- and four-year-olds*, Session 2010-12, HC 1789, National Audit Office, February 2012.

4 Comptroller and Auditor General, *Department of Health, Oversight of user choice and provider competition in care markets*, Session 2010-12, HC 1458, National Audit Office, September 2011.

5 See endnote 2.

6 Memorandum for Parliament, *Managing government suppliers*, Session 2013-14, HC 811, National Audit Office, November 2013. Public Accounts Committee Uncorrected Transcript of Oral Evidence, Monday 25 November 2013, HC 791-i.

7 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 100 and p. 119. The percentages of the ‘for-profit’ and ‘not-for-profit’ markets represented by each are: Four Seasons Healthcare 5.2 per cent; BUPA 4.8 per cent; HC-One 2.9 per cent; and Barchester Healthcare 2.7 per cent. (Laing & Buisson are a leading provider of information and market intelligence on care services.)

8 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 3.

9 The Laing & Buisson *Care of Elderly People Market Report*, January 2013, (p. 221) reports that weighted average fees for nursing homes amount to £731 per week in 2012-13. The Department of Health’s Payment by Results tariff information spreadsheet for 2012-13 shows that patients that are admitted for “fall without specific cause, without complications or comorbidities”, the long-stay payment in hospital is £209 per day (equivalent to £1,463 per week) once the patient stays past ten days. The actual payment would vary slightly depending on the market forces factor. The difference between the weekly rates is over £700.

10 The approach typically involves the local authority in agreement with local providers using a trustworthy, independent expert – the ‘honest broker’ – to survey and analyse the cost data of providers in the local market to arrive at a ‘reasonable’ cost of provision (based on for example weighted averages, and removing statistical outliers).

11 According to the 2011 census for England, more than half of 85-year-olds and over have care needs, which limit their day-to-day activities.

12 In addition, in early years provision, the ‘maintained’ sector is also significant comprising nursery classes run by maintained schools, and a relatively small number of maintained nursery schools.

13 The OFT will merge with the Competition Commission in April 2014 to form the Competition and Markets Authority.

14 In addition, Monitor has concurrent powers with the OFT that cover all healthcare markets, not just NHS-funded ones.

15 Office of Fair Trading, *Public bodies and competition law: A guide to the application of the Competition Act 1998*, OFT 1389, December 2011.

16 Public bodies should be aware that their conduct may also (or alternatively) be subject to other laws within the field of competition law, including public procurement, merger control or State aid laws, or both (see endnote 15, OFT 1389, p. 4).

17 HM Government, *Caring for our future: reforming care and support*, Cm 8378, July 2012. HM Government, *Care Bill explained*, Cm 8627, May 2013.

18 White Paper, Cm 8378, July 2012, p. 45.

19 The national programme was called ‘Developing Care Markets for Quality and Choice’ and was developed by Oxford Brookes University’s Institute of Public Care. For more information visit: <http://ipc.brookes.ac.uk>.

20 Childcare providers finance survey 2012 (p. 4) commissioned by the Department for Education found that childcare ‘settings based in the 30 per cent most deprived areas were less likely to make a profit or surplus than those in the least deprived areas’. The Laing & Buisson Children’s Nurseries Report 2011 reported that “the proportion of non-domestic childcare settings judged to be good or better, ranged from 75 per cent in the least deprived regions to 63 per cent in the most deprived”.

21 Local authorities have specific duties of care to their populations under Section 21(1)(a) of the National Assistance Act 1948 and Section 47(5) of the NHS and Community Care Act 1990. The NHS and Community Care Act 1990 gives local authorities the powers to provide or arrange care services for anyone in urgent need.

22 Department for Education, *Early education and childcare: statutory guidance for local authorities*, September 2013, (p. 3).

23 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 250.

- 24 B Brind et al. *Childcare Provider Finances Survey*, Department for Education Research Report DFE-RR213, May 2012, p. 12.
- 25 Laing & Buisson, *Children's Nurseries UK Market Report*, 2011.
- 26 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 240.
- 27 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 229.
- 28 Department for Children, Schools and Families, *Implementing the Early Years Single Funding Formula*, Practice Guidance, July 2009.
- 29 Comptroller and Auditor General, *Delivering the free entitlement to education for three- and four-year-olds*, Session 2010-12, HC 1789, National Audit Office, February 2012.
- 30 These are the Section 251 submissions from local authorities, part of their requirements under the Apprenticeship, Skills, Children and Learning Act 2009.
- 31 In social care, this option may ultimately lead to more private users exhausting their private resources earlier than they would have done (had private fee levels not had to be increased as much to compensate). Users have to fall back on the local authority to fund their assessed care needs.
- 32 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 241. Laing & Buisson produce specialist pricing reports for the care home industry; their toolkit draws on a financial care model developed by the Joseph Rowntree Foundation.
- 33 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 9.
- 34 Laing & Buisson, *Care of Elderly People UK Market Survey 2012/13*, January 2013, p. 226.
- 35 Department for Education, *Planned expenditure on schools, education, children and young people's services by local authorities: financial year 2013 to 2014*, September 2013, SR35 2013, Table 8.
- 36 Family and Childcare Trust (formerly known as the Daycare Trust and Family Parenting Institute), *Childcare Costs Survey 2013*, February 2013, p. 17.
- 37 Department for Education, *Provision for children under 5 years of age in England: January 2013*, June 2013, SFR23 2013, Table 7.
- 38 Family and Childcare Trust (formerly known as the Daycare Trust and Family and Parenting Institute), *Childcare Costs Survey 2013*, February 2013, p. 3.
- 39 National Day Nurseries Association, *UK Nursery Insight report*, June 2013.

- 40 HM Government, *Care Bill explained*, Cm 8627, May 2013, clauses 109–115. Consultation response to proposed oversight regime can be found at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/193856/Market_Oversight_Consultation_Response_-_1st_May_-_FINAL.pdf
- 41 The OFT informed us that local authorities are not normally classified as an ‘undertaking’ under the Competition Act 1998 (unless they also act as a service provider in the same market). This implies that competition law may be unlikely to apply to them.
- 42 The case involved the Committee of Care North East Newcastle and Newcastle City Council.
- 43 Department of Health, *Building Capacity Agreement*, October 2001.
- 44 The CQC inherited its inspection regime from the predecessor body (the Commission for Social Care Inspection) in 2009.
- 45 TNS BMRB (commissioned by Department for Education), *Childcare Provider Finances Survey*, May 2012. This report drew on evidence from ‘Effective Pre-school and Primary Education 3–11 Project (EPPE 3–11). Report from the Primary Phase: Pre-school, School and Family Influences on Children’s Development during Key Stage 2 (Age 7–11)’. Department for Children, Schools and Families Research Report 061.
- 46 ‘Non-domestic childcare settings’ means childcare that takes place outside the home; it excludes childcare by childminders in their own homes.
- 47 Laing & Buisson, *Children’s Nurseries UK Market Report*, 2011, p. 136.
- 48 See endnote 3.
- 49 Institute for Government, *Making public service markets work*, July 2013, p. 87.
- 50 For example, among others, *Evaluation of the Individual Budgets Pilot Programme*, October 2008 (www.york.ac.uk/inst/spru/pubs/pdf/IBSENSummaryReport.pdf); and In Control, *The National Personal Budget Survey*, June 2011 (www.in-control.org.uk).
- 51 NHS Information Centre, *Personal Social Services Adult Social Care Survey*, England 2012-13, Provisional results, July 2013 (www.hscic.gov.uk).



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