# Strawman description of payment mechanism option:
# Guaranteed maximum price with target cost, with profit at risk for outcomes/quality

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**Contents**



## 1. Purpose of the document

1.1. This is purely a strawman for the purposes of exploring in more detail how such a model might work. None of these aspects are yet decided, but should provide a starting point for detailed discussion.

1.2. This is one of two documents describing different payment mechanism models could work. The other document describes a model with firm priced volume bands.

## 2. Model overview

2.1. This is a target cost model with an incentive fee for both efficiency and the achievement of defined outcomes or quality levels, with painshare or gainshare if actual costs differ from target costs, and a maximum price above which costs would no longer be reimbursed.

## 3. Bidding and evaluation

3.1. In this model, bidders would bid a target cost for a range of different elements of the service (including back office/fixed costs). They would also bid their desired profit level, either per element or standard across all elements, which would be added to the target cost to give a target price. All of the elements would be added together to give an aggregate target price.

3.2. The Authority would provide expected minimum and maximum volume points for each service element. Bidders would bid a target cost for these minimum and maximum volume points for each element, and a number of intermediate volume bands, based on their operating model and when costs were likely to increase in line with volume (e.g., a significant increase in volume requires more staff and additional office space). We would not want bands to be too small, as we would not want there to be frequent changes of band, but they should also not be so large that significant deviation from the target cost would be expected at the lower or upper range of the band or that it would encourage challenges over individual cases. We would therefore perhaps set minimum and maximum numbers of bands.

3.3. Although the Authority would provide expected minimum and maximum volume points for each service element, it could not provide any guarantees. Therefore contracts would need to reflect how the price should be adjusted if volumes were outside of these ranges, within certain parameters.

3.4. Evaluation could be based on an average of the target prices at different volume points, for instance at the mid-point and the lower and upper points.

## 4. Guaranteed maximum price

4.1. The Authority would set the maximum price. This could be either based on the target price (as in the model services contract, where it is set at 10% above the target price) or on the target cost (where it would be set at a percentage higher than 10% to allow space for some profit, but which would give a similar level of cushioning against the target price regardless of providers' desired profit level). This would be standard across all providers and all elements.

## 5. Payment elements

5.1. We would propose the following separate payment elements. The Authority would provide expected minimum and maximum volume points for each element as part of the ITT. Bidders would provide volume bands in between the minimum and maximum points and a target cost for each band.

| **Element** | **Unit** |
|---|---|
| Sentence management / responsible officer duties<br>(includes licence and community RO work, pre- and post-release, resettlement, MHR/ATR/DRR) | Active cases OR sentence starts<br>Weight by complexity/tiering[1] and length? |
| Rehabilitation activity requirement | No of RARs OR<br>No of RAR days OR<br>Weighted by intensity |
| Accredited programmes | Programme starts |
| Unpaid work | Hours delivered |
| Remand releases | No of remand releases |
| Attendance centres | Hours delivered |
| Back office / fixed costs | Active cases OR sentence starts<br>Weight by complexity/tiering and length?<br>Or by number of frontline staff? |
| Mobilisation, transition, transformation costs | Perhaps variable but at wider (SM/RO) bands? |

## 6. Operation

6.1. Open book accounting would be required, and suppliers would provide monthly accounts showing full costs and income, with supporting information such as workforce data, payroll or copies of invoices. This would potentially include key supplier cost information. The information would be provided in a similar format to the financial response templates used in the bid, using templates provided by the Authority, to allow comparison to the costs that were bid.

6.2. A secure portal would ideally be provided to allow secure transfer and storage of information and audit trail, and automated messages when new information was provided or questions sent or answered.

6.3. If actual incurred costs were higher than the target cost, the incurred costs would still be paid if they were up to the maximum price, but the profit available would be reduced with a painshare

[1] A tiering framework is currently used by the NPS to allocate a service-user to an appropriate responsible officer, based on the expected amount and level of resource required to manage the case. The tiering is based on a number of factors which include risk of serious harm and risk of reoffending

between the Authority and the supplier of the difference between the actual and target costs. If actual incurred costs were lower than the target cost, the actual costs would be reimbursed, and the profit available would be increased with a gainshare between the Authority and the supplier of the difference between the actual and target costs. Differential gain and painshare could be applied on a tiered basis, and a profit cap could be applied to limit any additional profit being due below a certain point, to disincentivise excessive cost reduction at the expense of service delivery.

6.4. Although a target cost would be in operation for each element, the assessment of actual costs against target costs would likely be based on the aggregation of the target costs for all elements.

**Example 1:** Incurred Cost is lower than Target Cost (IC < TC)
Actual Payment = TP - ((TC-IC)/2)
Difference between incurred costs and target costs is shared equally between Authority and Supplier. i.e. Supplier receives higher Supplier Profit Margin.

**Example 2:** Incurred Cost higher than Target Cost (IC > TC)
Actual Payment = TP + ((IC-TC)/2) (Capped at Guaranteed Max Price (GMP))
Difference between incurred costs and target costs is shared equally between Authority and Supplier. I.e. Supplier receives lower Supplier Profit Margin (Capped at Guaranteed Max Price).

## 7. Awarding of profit

7.1. Although the availability of profit would be dependent on where actual costs were in relation to target costs, the actual awarding of profit would be dependent not only on whether costs were below the maximum price, but on whether a given outcome(s), service levels or quality level were achieved. Which outcome/service level/quality level is used is subject to the decisions in the performance framework workstream; the paymech will simply facilitate this.

## 8. Change of volume band

8.1. The expected volume levels for each element would be notified by the Authority three months before the new contract year, to provide an expectation of which target cost and price band would apply for the year. However, if there was a sustained change in volume which was or a reason to think the change would continue (e.g. a policy change), the Authority could, at its discretion, give a further three months' notice to apply the changed volume band and thus the applicable target cost and price. This would work in the same way for increases or decreases.

## 9. Payment and reconciliation

9.1. Based on the notified expected volume level, the target price would be paid at the end of each month in line with usual invoicing procedures and timescales. During the month following a given month's operation, the provider would submit their actual costs and the Authority would review these, and any discrepancies or queries would be addressed. Any reconciliation would be applied to a future invoice.

## 10. Allowable costs

10.1. As part of the approach to open book accounting, the contract would need to specify what types of actual costs were allowable, for instance third party liability claims would not be considered allowable. Consideration needs to be given about how best to do this and what level of detail would be required.

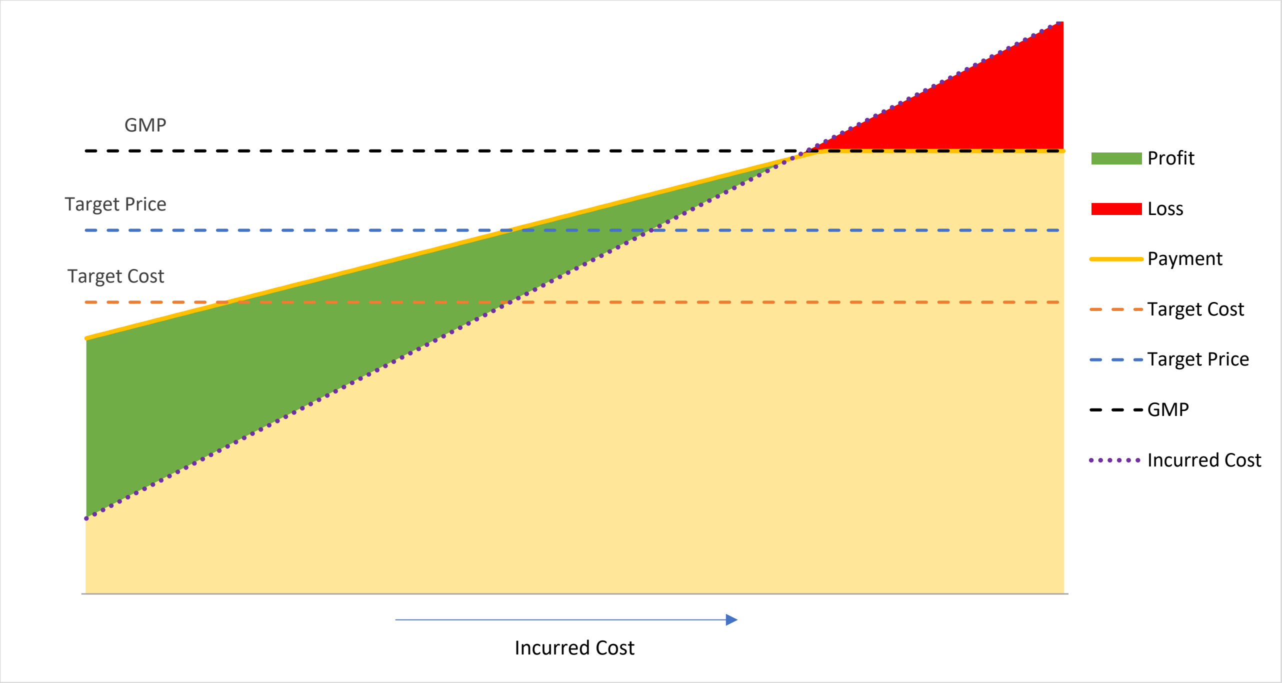
## 11. Service credits

11.1. If a single outcome or quality level is used for the awarding of profit, there may still be service levels and service credits for other performance measures. There is a question about how any service credits should be applied and whether incurred costs should be fully reimbursed if there has been a failure to deliver some services (in whole or part) or where services delivered are not to an acceptable quality.

## 12. Illustration

12.1. The following chart is for Illustration only, not to be used for making any calculations. Please note, the chart does not show any potential cap on profit that may be incorporated into the model.

Illustration of GMPTC (fixed volume):



## 13. Questions

The questions in this section will be discussed at the market engagement event.

| Area of model | Sub-area | Further details | Questions |
|---|---|---|---|
| Bidding and evaluation | Bidders bid a target cost and target profit % for different elements of the service, at bidder-determined volume points for each element, within Authority-provided minimum and maximum volume points.<br>Evaluation could be based on an average of the target prices at different volume points | | 1. Should different elements have different profit levels, e.g. between front and back office aspects or between different services?<br>2. Is it correct that bidders should set their own volume bands, within a minimum and maximum number of bands?<br>3. If so, is more guidance required on how to do so?<br>4. Are there any issues with evaluating at the mid-point given there will be different volume bands between the lower and upper points? Will this lead to misalignment of incentives around the banding? |
| Guaranteed maximum price | The Authority would set the maximum price at a percentage above either the target cost or target price; this would be standard across all providers and all elements | For instance, 10% above the target price, or a higher % above the target cost | 5. Should the maximum price be based on target cost or target price, and why?<br>6. What % should it be set at, and what factors should we take into account when setting this?<br>7. Should it vary by element? |
| Payment elements | Mix of elements | | 8. Are these the right elements?<br>9. Are there any missing?<br>10. Would this mix of elements drive strong performance across all? |
| | Sentence management / responsible officer duties<br>(includes licence and community RO work, pre- and post-release, resettlement, MHR/ATR/DRR) | Active cases OR sentence starts<br>Weight by tiering and length? | 11. Should we use caseload or sentence starts?<br>12. Should either unit be adjusted for complexity / tiering and sentence length? |

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| | Rehabilitation activity requirement | No of RARs OR<br>No of RAR days OR<br>Weighted by intensity | 13. Should RAR be separate, given similar rehab activities are contained within OM/RO element for licences? NB the difference is that not all community orders will have a RAR.<br>14. If RAR is separate, should it be based on days, or intensity level, or no of RARs, or including tiering/areas of need?<br>15. If including (no/type) of areas of need, how should this be assessed and validated?<br>16. Could discretionary interventions for NPS service users be included here, and if so how?<br>17. Are there any cost differences between NPS and CRC users?<br>18. How should we account for rehabilitation interventions for people on licence? |
| | Accredited programmes | Programme starts | 19. Do different programmes have similar costs?<br>20. Are there any cost differences between NPS and CRC users? |
| | Unpaid work | Hours delivered | 21. Do additional requirements re intensive work, use of UPW for ETE or case mix of CRC/NPS and group/individual placement need to be factored in, or can an average cost be assumed? |
| | Remand releases | No of remand releases | 22. Should remands be separate given they are not within RO role? |
| | Attendance centres | Hours delivered | 23. Is this the correct payment method?<br>24. Is it worth a separate element given the numbers are so low, or should it be included within the RAR element (or SM/RO element if RAR not included separately)? |
| | Back office / fixed costs | Active cases OR sentence starts<br>Weight by tiering and length?<br>Or by number of frontline staff? | 25. What should be included here?<br>26. Are there elements (e.g. office space, programme rooms) which are better included in the frontline elements?<br>27. Should this be fixed or based on volume bands? If volume bands, based simply on numbers of starts/caseload, or including case mix (depends partly on which unit chosen for SM/RO, |

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| | | | though could be based only on numbers even if weighted unit used above)?<br>28. How would this be affected with multiple lots?<br>29. Should this be subject to target cost or excluded (i.e. fixed per volume band)? And/or, should fixed costs be excluded from profits and simply passed through? |
| | Mobilisation, transition, transformation costs | Perhaps variable but at wider (OM) bands? | 30. Is this variable according to volume? |
| Operation | Suppliers would provide monthly accounts showing full costs and income, with supporting information such as copies of invoices or payroll if required. | Authority-provided template, similar to bid financial submission<br>Secure portal for information transfer and storage | 31. Does open-book accounting present any challenges; if so how would you address them?<br>32. Would providing monthly information using a similar template to the financial response submission at bid stage cause any difficulties?<br>33. Are there any specific requirements re how to share cost information (e.g. using secure portal) we should consider?<br>34. How should gainshare and painshare be split? 50/50? Or differential gain/painshare on a tiered basis?<br>35. At what level would you have concerns about a profit cap?<br>36. Is aggregating all target costs for all elements correct (aside from back office/fixed/indirect)? |
| Awarding of profit | Availability of profit dependent on actual costs in relation to target costs, but actual awarding of profit dependent on whether a given outcome(s), service levels or quality level were achieved | (Given outcome(s), service levels or quality level still to be decided) | 37. Should all profit be based on outcome/quality levels?<br>38. Should different levels of profit be available for different levels of outcomes/quality levels?<br>39. How should this work – as a multiplier of basic profit, or a % available? If the latter, how exactly should this work? |
| Change of volume band | Expected volume bands and thus target costs and prices notified by the Authority three months before new | | 40. Is it correct that target price would be based on expected rather than actual volume levels? |

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| | contract year; changes could be notified mid-year if sustained or expected to be sustained and then further notice given | | 41. What notice of a target cost band change would be correct, and with what triggers? Should these periods be the same for increases and decreases? |
| Payment and reconciliation | Target price for notified volume band paid at end of each month. Reconciliation and payment adjustment carried out later. | | 42. Would this reconciliation process cause any issues?<br>43. What time period would you consider appropriate for reconciliation? |
| Allowable costs | The contract would need to specify what types of actual costs were allowable, for instance third party liability claims would not be considered allowable | Further details yet to be considered | 44. Do you have any comments on this? |
| Service credits | If an outcome or quality level is chosen for profit to be based on, there could still also be reduced payments due to service credits against service levels | | 45. If there is a failure to deliver some services, should any costs incurred in relation to those services be fully reimbursed? |
| Applicability over contract life | | | 46. To what extent would you expect to achieve efficiency improvements over the contract life?<br>47. How should inflation be applied? Should different indexes apply to different aspects? |
| Wider impacts | | | 48. How would this model impact supply chain providers?<br>49. What elements of risk, if any, would you expect to pass to supply chain providers?<br>50. Would this model create any barriers to entry? |
| Model overview | | | 51. Overall, do you think this is the right model? If not, why not? |

**Please send any feedback and comments to ProbationCommercialTeam@justice.gov.uk.**