

# **Commissioning and competition in the public sector**

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# 1 EXECUTIVE SUMMARY

- 1.1 The public sector spends around £220 billion<sup>1</sup> (or around 15 per cent of GDP) on the purchase of goods and services from the private and the third sectors. In 2008-09, one-third of this spending was by central government, with the remaining two thirds accounted by local authorities, NHS trusts, schools and other local public bodies. It is important that commissioning and procurement processes<sup>2</sup> are as efficient and effective as possible to gain maximum value for money<sup>3</sup> for both the Government and taxpayer.
- 1.2 Effective competition can play an important role in promoting efficiency and innovation, resulting in enduring value for money. Competition can create a dynamic market in which end users choose those suppliers which offer the best value for money, and suppliers face appropriate incentives to offer better value for money or risk losing contracts or market share. This, in turn, can generate increased economic growth and greater prosperity.
- 1.3 Public services commissioning and procurement, however, does not always fully realise these potential benefits to competition. Instead, commissioners and procurers too often take a simplistic approach to achieving competition assuming it is sufficient to have an open and transparent tender process that attracts more than one bidder. While this is an important feature, effective competition requires far more than this. It involves ensuring public services markets are contestable, both over the short-term and long-term, while also ensuring commissioners, procurers and suppliers all have the right incentives to improve quality of service, efficiency and innovation.

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<sup>1</sup> Source: *Public Expenditure Statistical Analyses 2009*, HM Treasury, [www.hm-treasury.gov.uk/pespub\\_pesa09.htm](http://www.hm-treasury.gov.uk/pespub_pesa09.htm).

<sup>2</sup> Where 'commissioning' is the cycle of assessing the needs of people in an area, designing and then achieving appropriate outcomes and 'procurement' is the actual purchase of goods and services.

<sup>3</sup> Where 'value for money' not only measures the financial cost of the good and service, but also takes account of quality, service, innovation, fitness for purpose and resource use.

- 1.4 This study complements, and adds value to, ongoing reform initiatives being implemented across Government. In particular, the Government has announced a series of measures to improve efficiency and reform procurement practices and processes. These are being led by the Efficiency and Reform Group (ERG) in the Cabinet Office.<sup>4</sup> Alongside these measures, the Government has announced a reform programme for public services designed to improve efficiency and quality, and to encourage greater participation by a wider range of suppliers, in the delivery of public services and enhance end user choice.<sup>5</sup> These initiatives are designed to have a significant impact on how public services are commissioned and procured. The OFT regards it as vital, in this context, that commissioners and procurers in the public sector are competent and strategic buyers, fully aware of market dynamics and making the best use of competitive frameworks to promote economic growth.
- 1.5 The aim of this study is to signal a key means of achieving greater efficiencies in commissioning and procurement practices and processes by highlighting the role competition can play in achieving value for money in the delivery of public services and wider growth. While this study is not comprehensive, it seeks to provide constructive and practical insights for commissioners and procurers of public services in local, central and devolved government when designing or implementing commissioning and procurement strategies to help them promote competition in public services markets.
- 1.6 On the basis of new empirical research derived from detailed, practical case studies,<sup>6</sup> we have identified some important insights and practical

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<sup>4</sup> Early examples of initiatives in this area include an efficiency review by Sir Philip Green and measures designed to reduce barriers to entry for SMEs and other suppliers to participate in public service markets. Further details can be found at [www.cabinetoffice.gov.uk/government-efficiency](http://www.cabinetoffice.gov.uk/government-efficiency).

<sup>5</sup> Further details can be found at: [www.cabinetoffice.gov.uk/big-society](http://www.cabinetoffice.gov.uk/big-society).

<sup>6</sup> These case studies have been carried out by PwC on behalf of the OFT and cover the Flexible New Deal, private sector involvement in the design, build and operation of prisons, the purchase of pension scheme administration services, hospital facilities management, residential care home places and the purchasing of supplies by schools. This research is published alongside this study: [www.of.gov.uk/shared\\_of/reports/comp\\_policy/commissioning+competition.pdf](http://www.of.gov.uk/shared_of/reports/comp_policy/commissioning+competition.pdf).

steps for commissioners and procurers purchasing goods and services for the public sector. These case studies were selected by the OFT on the basis of their relevance to current salient themes in commissioning and procurement, with each yielding a number of insights across multiple themes. In addition to these case studies, the OFT has, in the context of this study, also held detailed discussions with a number of commissioners and procurers in local, national and devolved government, suppliers and end user groups.

- 1.7 The OFT has identified four competition themes and worked up more detailed, constructive guidance in order that commissioners and procurers are better equipped to leverage competition to create open and contestable public services markets that incentivise suppliers to increase efficiency, improve quality of service provision and innovate.
- 1.8 These four themes are: tackling barriers to entry, tackling barriers to exit, achieving genuine choice, and aligning incentives. Each is discussed in further detail below.

### **Tackling barriers to entry**

- 1.9 The OFT's research has highlighted practices in which commissioning and procurement in public services markets can act to disadvantage some suppliers, or even prevent them from participating in the competition process at all. This will in turn tend to reduce the degree of genuine competition that occurs both over the short-run and long-run. The OFT's research has identified five relevant areas where there are particular risks of barriers to entry being created or enhanced in public services markets:

- the design and implementation of commissioning and procurement policies and processes
- the way in which contracts are aggregated or bundled together to provide multiple services
- the use of joint procurement projects by commissioners and procurers in different institutions
- the promotion, by commissioners and procurers, of new delivery models and contract types, and

- the use of framework agreements by the public sector.
- 1.10 Over-complex and burdensome procurement policies and processes can disadvantage some suppliers, or suppliers with less experience of supplying to the public sector. While there are clear benefits to such provisions, such as ensuring all suppliers meet minimum standards, particularly onerous policies and processes can act to limit participation. This can dampen competition in the market and potentially reduce innovation. Where possible, procurement policies and processes should be streamlined and consideration should be given not to go beyond the minimum required under EC regulation. The adoption of electronic based tools during procurement exercises and contract management, such as e-invoicing, can be a potentially effective way to reduce the administrative burden on suppliers and thereby increase participation.
- 1.11 It is well known that economies of scale and scope can achieve significant efficiencies in the delivery of public services. Large, aggregated contracts can also help reduce administrative costs for commissioners and procurers. However, large contracts can disadvantage suppliers who do not have capacity to deliver the aggregated outputs, but can provide individual services at potentially better value for money. Where practical, therefore, commissioners and procurers should consider disaggregating contracts for different public services to encourage the widest possible range of suppliers to participate.
- 1.12 Joint purchasing projects by commissioners and procurers can help achieve the benefits of greater buyer power. However, these projects can also, potentially, limit supplier participation through having larger contracts that smaller suppliers are unable to bid for. Joint purchasing projects should therefore review the potential impact on smaller suppliers' ability and incentives to compete in the procurement exercise. Consideration should be given by commissioners and procurers to dividing these contracts into separate lots to facilitate such entry, or at least weigh this option against potential economies of scale and scope arising from joint purchasing.
- 1.13 The OFT's research highlighted a number of newer delivery models that have the potential to widen participation rates, such as the formation of SME and third sector consortia or encouraging prime-contractors to sub-

contract to a broader range of suppliers. When designing, specifying or encouraging these new delivery models, commissioners and procurers should seek to ensure that suppliers are still incentivised to innovate and that sub-contractors are able to negotiate contractual terms with prime-contractors on an equal footing. Greater use, and the strengthening, of the Department for Work (DWP) and Pensions' Merlin Standard to promote high performing supply chains is a potentially effective route to achieve this.

- 1.14 The use of outcome based contracts can create incentives on suppliers of public services to innovate and make efficiency savings. However, commissioners and procurers should design such contracts in a way that does not dissuade new and/or smaller suppliers from participating in public services markets because they are less able to access up-front financing.
- 1.15 When private and third sector suppliers are bidding alongside public sector in-house suppliers to deliver public services, there is potential for bids to be compared in an unequal basis.<sup>7</sup> In order to ensure a level playing field, and thereby generate genuine competition, the cost of liabilities such as pensions and health and safety requirements should be factored in when assessing public sector in-house bids so as to ensure they are appropriately evaluated and there is a level playing field between all suppliers.
- 1.16 Framework contracts<sup>8</sup> can be useful for carrying out quick and effective purchasing on an ongoing basis. However, their use can inhibit new entry over their duration. This can raise particular concerns if other firms on the contract exit the market or merge. Consideration should therefore be given to re-designing framework contracts to allow commissioners and procurers to include additional suppliers during the life of the framework mechanism, if these suppliers can demonstrate they meet the

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<sup>7</sup> These are discussed in detail in the 2010 OFT report *Competition in mixed markets: ensuring competitive neutrality*, [www.offt.gov.uk/shared\\_offt/economic\\_research/oft1242.pdf](http://www.offt.gov.uk/shared_offt/economic_research/oft1242.pdf).

<sup>8</sup> Framework contracts or agreements are general terms for an arrangement with a named group of suppliers which set out terms and conditions under which specific purchases can be made throughout the duration of the agreement's term.

same objective criteria used to select existing suppliers within the framework.

## **Tackling barriers to exit**

- 1.17 Barriers to exit typically refer to factors that prevent or deter suppliers swiftly leaving a market. Barriers to exit can act to encourage inefficient suppliers to remain in the market and can have effect of discouraging new suppliers from entering the market, particularly if the financial costs to exit are high.
- 1.18 In public service markets, the exit of supplier, and disruption in the provision of service, can have significant costs. Commissioners and procurers often face conflicts between the need to 'punish' a provider for poor performance and the desire to ensure essential services are continuously supplied.
- 1.19 Where the public service must be continuously supplied, commissioners and procurers should seek to make contingency arrangements to minimise disruption to users of those services. However, any requirements on potential suppliers to ensure continuity of supply should take account of market conditions and their ability to make contingency arrangements in the event of market exit or supplier failure.
- 1.20 The costs of ensuring continuity of supply should not only be evaluated when assessing private and third sector bids. In evaluating public sector in-house supply options, the cost of failure of public sector suppliers should also be accounted for appropriately, and in a consistent manner, to avoid favouring in-house suppliers, even when they do not represent optimal value for money.
- 1.21 In mature public services markets with large and diverse supplier bases, commissioners and procurers should ensure that contracts with suppliers allow them to switch to more efficient suppliers in the event of poor performance effectively and swiftly.
- 1.22 However, commissioners and procurers need to ensure that, while the threat to switch from incumbent suppliers to potentially more efficient suppliers during a contractual period can create appropriate incentives on incumbent suppliers to improve their performance, new entrants should

not be deterred from entering a public market if they are concerned that contracts, once awarded, can be arbitrarily terminated.

### **Achieving genuine choice**

- 1.23 Discussions of competition are often overly focussed on the supply side, but the demand side is also crucial. Effective competition will work well to deliver what users want if those who make the choices are clear about their preferences and if they are able to observe and contract on the characteristics they value, including quality.
- 1.24 Where end users purchase public services directly, commissioners should seek to ensure that those end users have sufficient tools and information to exercise effective choice to drive competition.

### **Creating appropriate, aligned incentives to promote value for money**

- 1.25 In public services markets where end users only have limited choice due to the existence of a sole supplier or only a limited number of suppliers in the market, their ability to drive competition will be constrained. In such situations, it is important that commissioners and procurers are themselves correctly incentivised to achieve enduring value for money and also to ensure suppliers of public services are incentivised to do so as well.
- 1.26 If commissioners and procurers do not clearly articulate the strategic objectives of any given procurement exercise, this may make it harder to align suppliers' incentives to achieve value for money. Unclear or constantly changing strategic, guiding objectives have the potential to obscure suppliers' incentives to increase efficiency, improve quality and innovate.
- 1.27 Procurers and commissioners can also take a number of steps to ensure that suppliers are correctly incentivised to achieve value for money. These mechanisms, such as introducing 'payment by results' and ongoing rating schemes for suppliers, have the potential to create strong incentives for suppliers to improve their offering, but if implemented without fully considering the wider market, its impact on the nature of competition and the existing and potential supplier base, they can raise barriers to entry and exit.

1.28 By taking due account of these four themes at the early stages, commissioners and procurers can better engage in balancing some of the evident complex trade-offs involved in commissioning and procurement decisions around the delivery of public services. These trade-offs can include:

- **the choice between local or centralised procurement** - some services may be more amenable than others to being procured locally, however, there may be less scope for local procurement exercises to then, for example, secure volume discounts
- **the choice between large and small contracts** – joint procurement projects and the bundling of different service contracts may lead to significant, valuable economies of scale and scope and reduce administrative burdens, but may also reduce the ability of smaller suppliers to participate, and
- **the choice between short-term and the long-term** - there may be strong imperatives to make short-term cost savings through the choice of certain types of contracts and suppliers, but an excessive focus on short-term cost savings may be at the expense of creating dynamic markets over the long-term that are open, contestable and create the right incentives on suppliers to achieve and secure value for money.

1.29 It is vital to recognise that the focus and competency with which commissioners and procurers balance each trade-off will significantly influence outcomes across public service markets. Focusing solely on achieving the lowest possible tender price today, may lead to a narrow supplier base tomorrow with reduced incentives to improve quality and innovate, making it harder to achieve value for money in the long term and ultimately result in reduced economic growth.

### **Next steps**

1.30 This study forms part of the OFT's wider portfolio of work across public markets. Building on the OFT's track record of delivering market-based solutions that benefit users, and its previous experience of examining the

role of Government in markets,<sup>9</sup> the OFT is currently working with, and guiding policy making by, Government departments undertaking reviews of, and reform initiatives related to, commissioning and procurement.<sup>10</sup>

- 1.31 As one of its current priority areas, as signalled its Annual Plan 2010-11,<sup>11</sup> the OFT will continue to take an active interest in public services markets and remains ready to use its spectrum of competition and consumer tools, including Competition Act 1998 enforcement action, if appropriate, to address instances where suppliers active in public services engage in agreements and conduct which prevents, restricts or distorts competition, and conduct which constitutes an abuse of a dominant position.

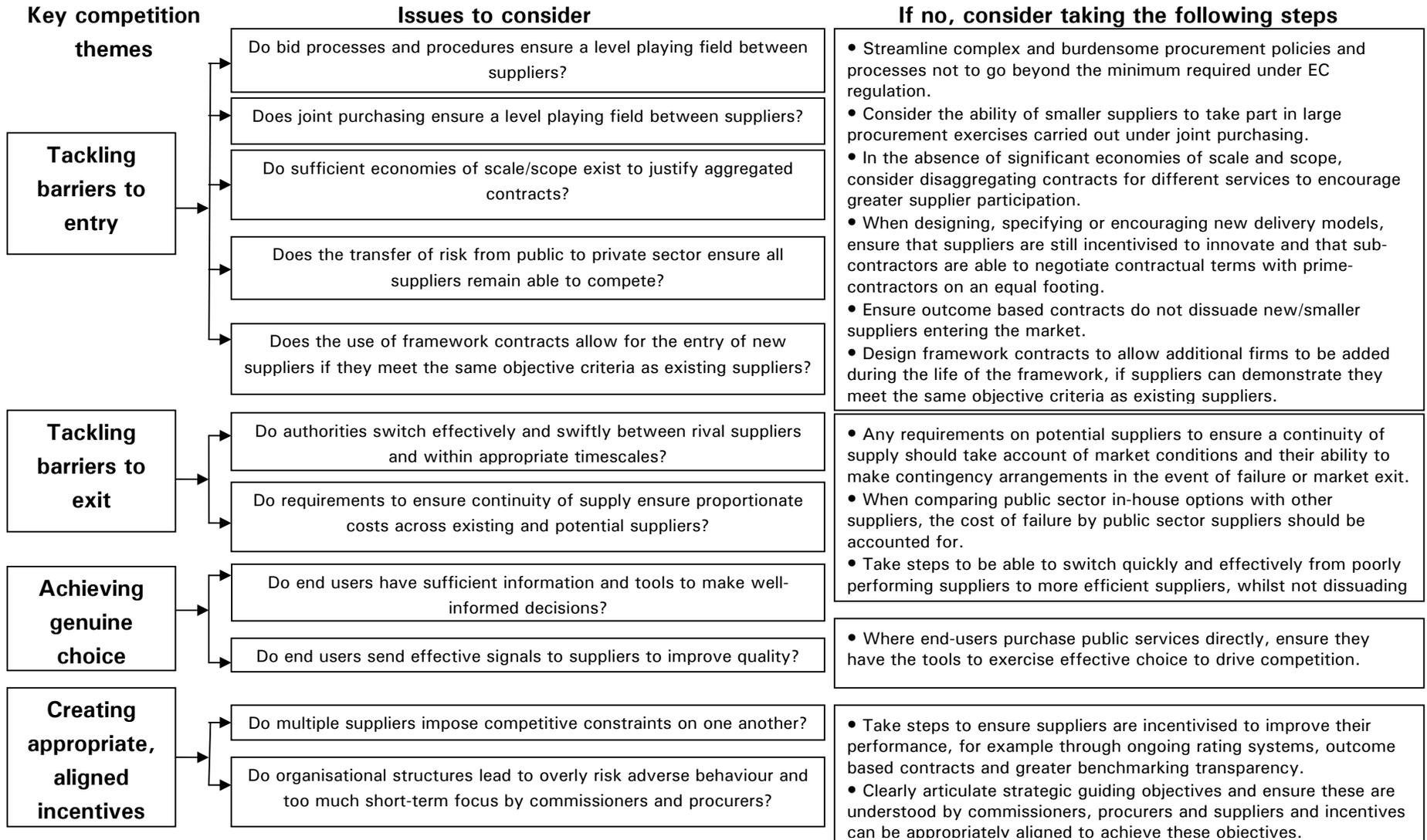
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<sup>9</sup> A full list of relevant studies by the OFT in these areas is placed in Annexe C.

<sup>10</sup> See [www.hm-treasury.gov.uk/ukecon\\_growth\\_index.htm](http://www.hm-treasury.gov.uk/ukecon_growth_index.htm).

<sup>11</sup> See OFT Annual Plan 2010-11, [www.oft.gov.uk/shared\\_of/about\\_of/706647/oft1215.pdf](http://www.oft.gov.uk/shared_of/about_of/706647/oft1215.pdf).

**Figure 1.1: Key competition themes in commissioning and procurement**



## 2 INTRODUCTION

- 2.1 The public sector is estimated to have spent approximately £220 billion<sup>12</sup> on the procurement of goods and services from the private and third sectors in 2008-09. Around one third of this spending was by central government, with the remaining two thirds accounted for by local authorities, NHS trusts, schools, and other local public bodies.<sup>13</sup>
- 2.2 The Spending Review 2010 has set out the Government's ambitions to make a total of £81 billion savings by 2014-15.<sup>14</sup> Given that procurement spending on goods and services accounts for 35 per cent of all public sector expenditure,<sup>15</sup> a proportion of this spending reduction is expected to be achieved through greater efficiencies in the procurement of goods and services in the provision of public services.
- 2.3 The aim of this study is to signal a key means of achieving greater efficiencies in commissioning and procurement practices and processes by highlighting the role competition can play in achieving value for money in the delivery of public services and wider economic growth. While this study is not comprehensive, the study seeks to provide constructive and practical insights for commissioners and procurers of public services in local, central and devolved government to consider when designing or implementing commissioning and procurement strategies to help them promote competition in public services markets.

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<sup>12</sup> Source: *Public Expenditure Statistical Analyses 2009*, HM Treasury, [www.hm-treasury.gov.uk/pespub\\_pes09.htm](http://www.hm-treasury.gov.uk/pespub_pes09.htm). This figure includes both current and capital expenditure.

<sup>13</sup> Ibid.

<sup>14</sup> See *Spending Review 2010*, [http://cdn.hm-treasury.gov.uk/sr2010\\_completereport.pdf](http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf) for more details.

<sup>15</sup> As quoted in *Delivering More for Less: The Changes Taking Place in Government Procurement* by John Collington, available at [http://network.civilservicelive.com/action/file/download?file\\_guid=521395](http://network.civilservicelive.com/action/file/download?file_guid=521395).

## Context of this report

2.4 The Government has announced a series of measures designed to improve efficiency and reform procurement practices and processes in support of the fiscal consolidation planned in the current Spending Review period. These are being led by the ERG in the Cabinet Office. A list of initiatives implemented, or planned, is included in Annexe B, with the most relevant for this study being:

- a review by Sir Philip Green, published in October 2010, examining Government Spending and making a number of recommendations to Government on how it can better 'leverage both its credit rating and its scale' to improve commodity procurement, property and major contracts<sup>16</sup> a package of measures<sup>17</sup> announced in February 2011 designed to make it easier for small and medium-sized enterprises (SMEs) and third-sector organisations to compete for government contracts including, among other things, the launch of a 'Contracts Finder' website to increase transparency and aiming to eliminate the use of pre-qualification questionnaires for central government contracts under £100,000, and
- the publication in February 2011 of a Lean Review<sup>18</sup> on procurement processes which identified significant potential to reduce turnaround

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<sup>16</sup> See *Efficiency Review by Philip Green – Key findings and recommendations* <http://download.cabinetoffice.gov.uk/efficiency/sirphilipgreenreview.pdf>.

<sup>17</sup> For a full list of these measures see [www.cabinetoffice.gov.uk/news/government-opens-contracts-small-business](http://www.cabinetoffice.gov.uk/news/government-opens-contracts-small-business).

<sup>18</sup> See *Accelerating Government Procurement: Management Summary of the findings of a 'lean' study to investigate waste and inefficiencies in government's procurement process*, [www.cabinetoffice.gov.uk/sites/default/files/resources/lean-study-accelerating-government-procurement.pdf](http://www.cabinetoffice.gov.uk/sites/default/files/resources/lean-study-accelerating-government-procurement.pdf).

times<sup>19</sup> in procurement processes, costs to participating suppliers and related government resource and processing costs.

- 2.5 The Government has also recently concluded a consultation on public services reform<sup>20</sup> which sought views on the commissioning and delivery of public services.
- 2.6 There have also been specific initiatives around commissioning and procurement in Scotland, Wales and Northern Ireland. In Wales, the Efficiency and Innovation Programme and Board aims to promote better use of technology such as joining-up ICT improvements across the Welsh public sector, increased use of joint procurement exercises and to encourage innovation in the delivery of public services<sup>21</sup> and has recently published the conclusions and recommendations of its procurement taskforce. In Scotland, following the 2006 McClelland report,<sup>22</sup> a Public Procurement Reform Programme was initiated whose objectives included, among other things, facilitating public bodies in improving their procurement capabilities in order to support delivery of better public services and encourage suppliers to build effective and mutually beneficial relationships with the Scottish public sector. The Scottish Government has recently concluded a consultation on the standardisation of pre-qualification questionnaires (PQQs)<sup>23</sup> and currently has a number of relevant, ongoing initiatives, such as the sponsorship of

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<sup>19</sup> The 'turnaround time' refers to the time taken between going out to tender for a contract and the award of the contract itself.

<sup>20</sup> See [www.cabinetoffice.gov.uk/news/modernising-commissioning-green-paper-published](http://www.cabinetoffice.gov.uk/news/modernising-commissioning-green-paper-published) and [www.cabinetoffice.gov.uk/sites/default/files/resources/commissioning-green-paper.pdf](http://www.cabinetoffice.gov.uk/sites/default/files/resources/commissioning-green-paper.pdf).

<sup>21</sup> See <http://wales.gov.uk/docs/dpsp/publications/101711eisleafleten.pdf>

<sup>22</sup> The date of the Review of Public Procurement in Scotland report by John McClelland CBE, [www.scotland.gov.uk/Publications/2006/03/14105448/0](http://www.scotland.gov.uk/Publications/2006/03/14105448/0).

<sup>23</sup> See [www.scotland.gov.uk/Topics/Government/Procurement/Procurement-News/sPQQconsultation](http://www.scotland.gov.uk/Topics/Government/Procurement/Procurement-News/sPQQconsultation).

training on the EU Public Procurement Directive for procurement professionals in the Scottish public sector.<sup>24</sup>

- 2.7 The European Commission is also currently consulting on the modernisation of EU procurement policies.<sup>25</sup> Its Green Paper seeks views on possible reform and legislative options on a number of themes including the simplification of current procedures, reducing bureaucracy faced by potential suppliers and the promotion of competition in procurement markets.
- 2.8 Together, these initiatives are designed to have a significant impact on how public services are commissioned and procured. The OFT regards it as vital, in this context, that commissioners and procurers in the public sector are competent and strategic buyers, fully aware of market dynamics and making the best use of competitive frameworks to promote economic growth.

### **The OFT's approach and structure of the study**

- 2.9 The OFT's mission is to make markets work well for consumers. Our powers under competition and consumer law not only allow us to tackle anti-competitive behaviour by companies but also to address public restrictions on competition. They also place a responsibility on us to provide information and advice to Government on competition and consumer issues.<sup>26</sup>
- 2.10 The aim of this study is to signal a key means of achieving greater efficiencies in commissioning and procurement practices and processes by highlighting the role competition can play in achieving value for

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<sup>24</sup> See [www.scotland.gov.uk/Topics/Government/Procurement](http://www.scotland.gov.uk/Topics/Government/Procurement) for further details.

<sup>25</sup> See [http://ec.europa.eu/internal\\_market/publicprocurement/modernising\\_rules/consultations/index\\_en.htm](http://ec.europa.eu/internal_market/publicprocurement/modernising_rules/consultations/index_en.htm).

<sup>26</sup> See section 7 of the Enterprise Act 2002.

money in the delivery of public services and wider economic growth. By creating dynamic markets in which end users can drive effective competition and suppliers face appropriate, aligned incentives to offer better value for money and innovate or risk losing contracts or market share, competition can play a key role in promoting efficiency and innovation in the delivery of public services, which, in turn, can result in increased economic growth and greater prosperity. A failure to recognise and promote competition properly can lead to less open markets, lost dynamic efficiencies and reduced incentives on suppliers to innovate and achieve value for money.

- 2.11 The study forms part of the OFT's wider portfolio of work across public markets.<sup>27</sup> Building on the OFT's track record of delivering market-based solutions that benefit users, and its previous experience of examining the role of Government in markets,<sup>28</sup> the OFT is currently working with, and guiding policy making by, Government departments undertaking reviews of, and reform initiatives related to, commissioning and procurement.
- 2.12 Given the coverage of commodity procurement in other recent studies,<sup>29</sup> the focus of this study is predominantly on the commissioning and procurement of services, although many of the observations will equally apply.
- 2.13 In carrying out this study, the OFT has supplemented its existing knowledge base by collecting a range of empirical evidence to identify the key salient issues from a competition perspective in commissioning and procurement of public services across local, national and devolved government. The main elements of the OFT's approach to gathering evidence for this study have included:

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<sup>27</sup> See OFT Annual Plan 2010-11, [www.offt.gov.uk/shared\\_offt/about\\_offt/706647/oft1215.pdf](http://www.offt.gov.uk/shared_offt/about_offt/706647/oft1215.pdf).

<sup>28</sup> A full list of relevant studies by the OFT in these areas is placed in Annexe C.

<sup>29</sup> For example, the Sir Philip Green review.

- detailed discussions with a range of commissioners and procurers across local, central and devolved government
- detailed discussions with a range of suppliers, industry bodies and associations and other professionals associated with public procurement, and
- reviewing publicly available data.

2.14 This evidence gathering took place intensively between December 2010 and February 2011. A list of parties consulted by the OFT or who submitted evidence to the OFT is placed in Annexe A. In addition to the parties listed, we discussed with, or received evidence on these issues from, policymakers, commissioners and procurers in other government departments and the devolved governments in Scotland, Wales and Northern Ireland.

2.15 In addition to its own empirical research, as part of this study, the OFT commissioned PwC to gather evidence on the impact of commissioning and procurement on competition in public services markets through the use of case study analysis. These case studies, which were chosen in consultation with the OFT, have been selected on the basis of their relevance to current salient themes in commissioning and procurement. The six case studies are:

- private sector involvement in prisons: design, build and operation
- adult residential care home places
- school supplies
- pension scheme administration services for the National Employees Savings Trust Corporation (NEST) known as the Pensions Accounts Delivery Authority (PADA)
- hospital facilities management, and
- the Flexible New Deal.

2.16 In addition, PwC have carried out an international comparative case study examining the commissioning and procurement of welfare to work initiatives in Australia and the United States. The PwC research is published simultaneously with this study and is available on the OFT's website.<sup>30</sup>

2.17 On the basis of both sets of empirical research, the OFT has identified four competition themes and worked up more detailed and constructive guidance in order that commissioners and procurers are better equipped to leverage competition to create open and contestable public services markets to incentivise suppliers to increase efficiency, improve quality of service provision and innovate. These four themes are:

- barriers to entry
- barriers to exit
- choice, and
- incentives.

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<sup>30</sup> [www.oft.gov.uk/shared\\_oftrreports/comp\\_policy/commissioning+competition.pdf](http://www.oft.gov.uk/shared_oftrreports/comp_policy/commissioning+competition.pdf)

### 3 COMPETITION AND THE PROVISION OF PUBLIC SERVICES

#### Key insights:

- Competition can play a key role in achieving greater efficiencies in commissioning and procurement practices and processes.
- Competition can create dynamic markets in which end users can drive effective competition and suppliers face appropriate, aligned incentives to offer better value for money and innovate or risk losing contracts or market share. This, in turn, can result in increased economic growth and greater prosperity.
- A failure to recognise and promote competition properly can lead to less open markets, lost dynamic efficiencies and reduced incentives on suppliers to innovate and achieve value for money.

3.1 The term 'value for money'<sup>31</sup> is used to assess whether or not an individual or an organisation has achieved the maximum possible benefit from the goods and services it buys, with the resources available to it. It entails achieving the optimum balance between achieving low costs (economy), high productivity (efficiency) and successful outcomes (effectiveness). It, therefore, not only measures the financial cost of the good or service, but also takes into account quality, fitness for purpose, timeliness and resource use over its lifetime.

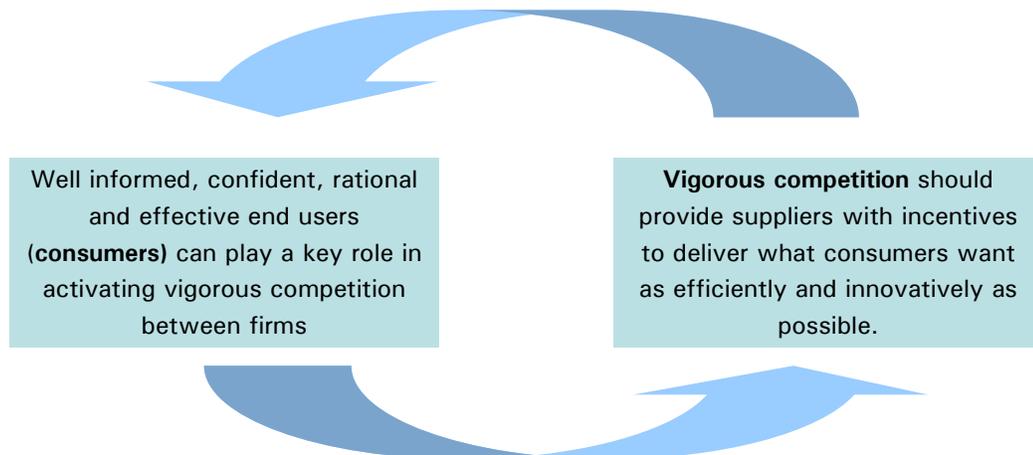
3.2 Competition – defined as the process of rivalry between suppliers seeking to win business from consumers - is a key contributor to achieving value for money. For competition to be effective, both sides of markets need to work well. On the demand side, end users need to be able make well-informed effective decisions and on the supply side, suppliers need to face incentives to deliver goods and services as efficiently and innovatively as possible. Figure 3.1 below illustrates how

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<sup>31</sup> There are many definitions of value for money. For example see [www.admin.cam.ac.uk/offices/secretariat/vfm/guide.html](http://www.admin.cam.ac.uk/offices/secretariat/vfm/guide.html).

the demand and supply sides can combine effectively to create a virtuous circle leading to market outcomes that work are in the interests of end users.

**Figure 3.1: The virtuous circle between end users and competition**



Adapted from OFT(1224)<sup>32</sup>

3.3 When active and rational end users and vigorous competition work together in tandem they can result in markets in which end users are able create the right incentives for suppliers to offer better value for money and innovate or risk losing market share. The failure of either side of the circle undermines the overall effectiveness of markets.

### Commissioning and procurement in the public sector

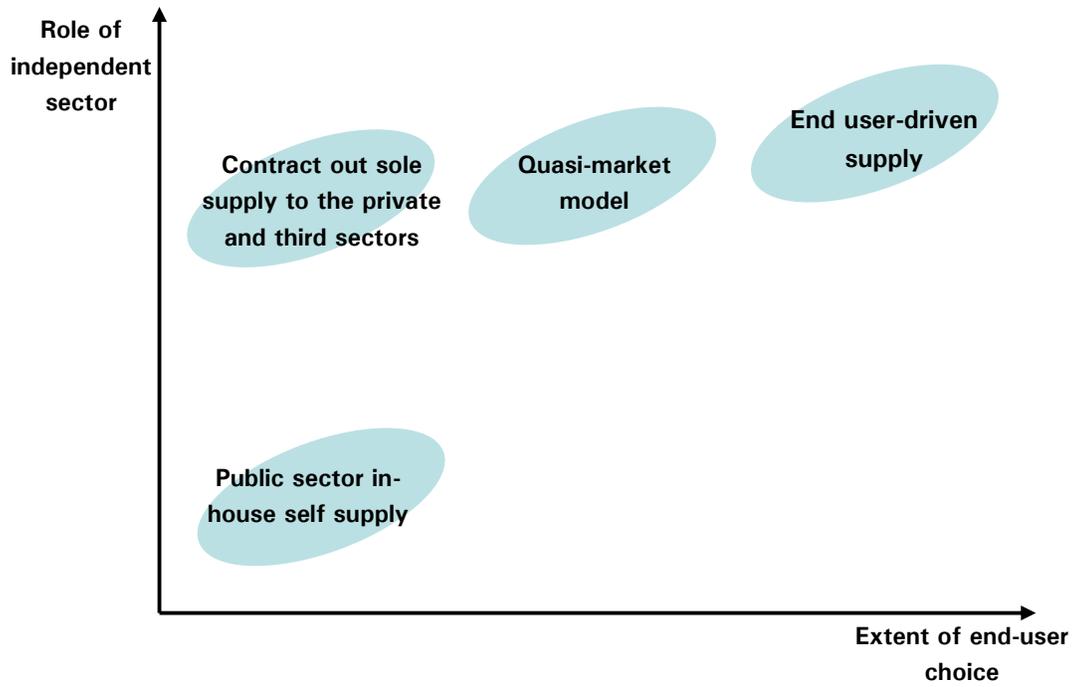
3.4 To date, local, central and devolved government has often acted as the monopoly supplier of public services in the UK and not been subject to vigorous competition. Figure 3.2 below illustrates the different models of public services provision. Recent and current Government initiatives related to commissioning and procurement appear to be motivated,

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<sup>32</sup> See *What does Behavioural Economics mean for Competition Policy?*  
[www.of.gov.uk/shared\\_of/economic\\_research/of1224.pdf](http://www.of.gov.uk/shared_of/economic_research/of1224.pdf).

however, to achieve greater competition and choice in public services markets through the involvement of private and third sector suppliers.<sup>33</sup>

**Figure 3.2: Different models of public services provision<sup>34</sup>**



3.5 Public sector in-house<sup>35</sup> self supply or inviting suppliers to bid for the opportunity to be the sole supplier (what is known as 'competition for the market') – historically the classic models of public services delivery – usually result in only one provider of public services and thereby the

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<sup>33</sup> For brevity, we use the term 'independent sector' to refer collectively to both for-profit firms in the 'private' sector and third-sector organisations, such as charities, social enterprises and other voluntary organisations.

<sup>34</sup> These categories are not definitive and are deliberately broad-brush. Further, the models are not static, meaning, for example, a quasi-market model can evolve into one that is consumer driven.

<sup>35</sup> That is, when the service is provided, and financed, by the public sector itself.

scope for end user choice is limited.<sup>36</sup> As the diversity and number of suppliers to deliver public services increases, the ability of end users to exercise a choice between suppliers, regardless of whether these suppliers are in the public or private and third sectors, will increase.

- 3.6 The decision about which public services provision model to use will depend on a range of factors such as the ability of end users (or others on their behalf) to exercise choice, the number of existing and potential suppliers and the nature of the particular public service and the market. Each model brings with it different issues and challenges. In some sectors, it may remain the case that end users' best interests are served through monopoly in-house provision whilst in other sectors it may be more appropriate for end users to exercise effective choice directly between rival suppliers and achieve the desired outcomes.<sup>37</sup>

### **Key actors involved in commissioning and procurement in public services markets**

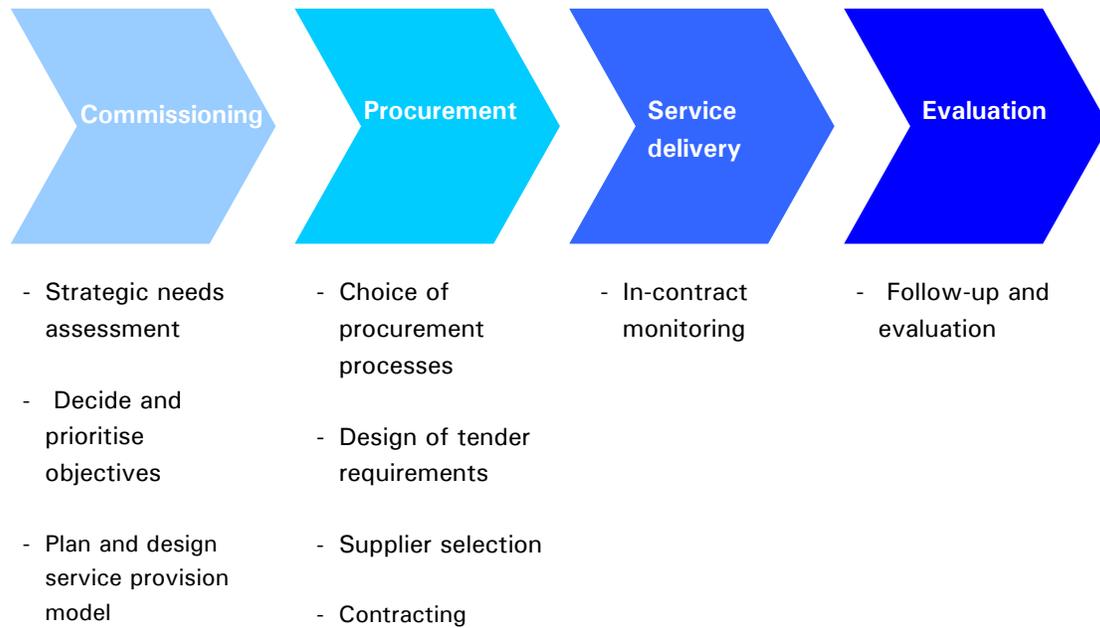
- 3.7 The different stages of commissioning and procurement can be broadly summarised as:

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<sup>36</sup> For example, end users may have a limited choice under a monopoly supplier in terms of which NHS hospital or public school they use.

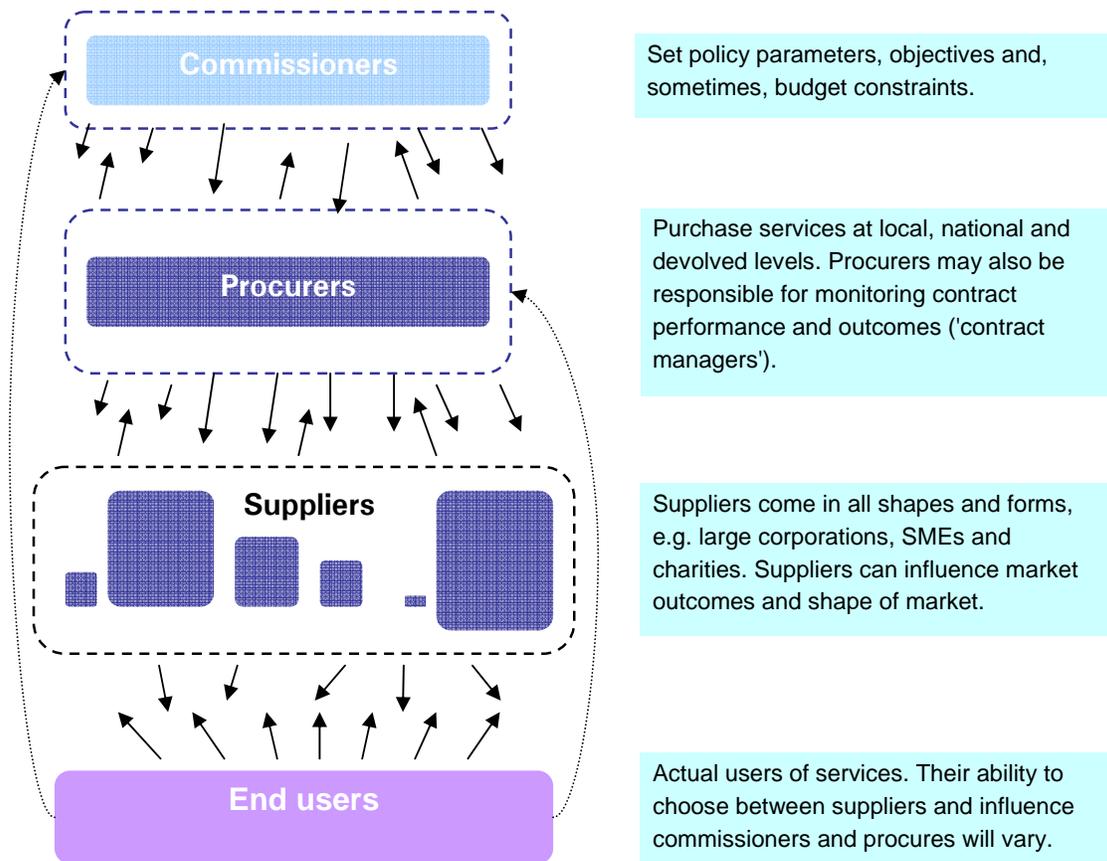
<sup>37</sup> Questions regarding which services are best provided through different procurement models are outside the scope of this study.

**Figure 3.3: Commissioning and procurement stages**



3.8 As Figure 3.3 suggests, the commissioning and procurement of public services involves a range of actors. Some of these actors are only involved at particular stages of the commissioning and procurement cycle, while others are involved across all stages. Figure 3.4 illustrates the different roles actors involved in commissioning and procurement have and how they interact and influence one another.

**Figure 3.4: Actors in the commissioning and procurement process**



Note: the arrows depict the ability of each actor to influence one another.

- 3.9 Commissioners can include Ministers, other politicians and civil servants. Procurers can refer to individuals (who may or may not be procurement specialists) or departments dedicated to procurement. Suppliers can be drawn from public sector in-house suppliers or from the private and third sectors. While public services will ultimately be consumed by end users (or consumers), in a number of instances these consumers may not be in a position to exercise choice directly and the choice of supplier is taken on their behalf.
- 3.10 As will be discussed in the following chapters, if value for money in public services markets is to be achieved, the incentives and preferences

of all the key actors in the commissioning and procurement process need to be appropriately tailored, aligned and understood.

### The different options for carrying out procurement exercises

3.11 If commissioners and procurers do decide to open up a public services market and to seek private or third sector involvement in public services provision, the way the procurement exercise is conducted will be subject to a legal framework set out in EC Procurement Directives<sup>38</sup> and UK law.<sup>39</sup> The regulations set out four award procedures for public sector procurement contracts:

- the **open procedure** under which any interested supplier may respond to an advertisement in the Official Journal of the EU (OJEU) by tendering for the contract
- the **restricted procedure** under which there are two-stages where only a selection of suppliers who respond to an advertisement are invited to submit a tender for the contract
- the **competitive dialogue procedure** where following an OJEU contract notice and a selection process, the public sector enters into a dialogue with potential bidders to develop one or more suitable solutions for its requirements and on which chosen bidders will then be invited to tender, and

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<sup>38</sup> These include Directive 2004/17/EC coordinating the procurement procedures of entities operating in the water, energy, transport and postal services sectors and Directive 2004/18/EC on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts. These can be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:134:0001:0113:en:PDF> and <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004L0018:EN:HTML> respectively.

<sup>39</sup> Through the Public Contracts Regulations 2006 for England, Wales and Northern Ireland and the Public Contracts (Scotland) Regulations 2006 for Scotland. These can be found at [www.legislation.gov.uk/ukxi/2006/5/contents/made](http://www.legislation.gov.uk/ukxi/2006/5/contents/made) and [www.legislation.gov.uk/ssi/2006/1/contents/made](http://www.legislation.gov.uk/ssi/2006/1/contents/made) respectively.

- the **negotiated procedure** under which the public sector can select one or more potential bidders with whom to negotiate the terms of the contract – the advertisement does not always have to be placed in the OJEU.

3.12 As set out in previous guidance by the Office of Government Commerce,<sup>40</sup> the regulations also provide for framework agreements, electronic auctions and dynamic purchasing systems. These are discussed in more detail in Chapter 4.

### The benefits of achieving effective competition in public services commissioning and procurement

3.13 As shown in Figure 3.5, competition in public services markets can result in increased economic growth and greater prosperity.

**Figure 3.5: Commissioning and economic growth**



3.14 By creating dynamic markets in which end users can drive effective competition and suppliers face appropriate, aligned incentives to offer

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<sup>40</sup> See *EU procurement guidance: Introduction to the EU procurement rules*, [www.ogc.gov.uk/documents/Introduction\\_to\\_the\\_EU\\_rules.pdf](http://www.ogc.gov.uk/documents/Introduction_to_the_EU_rules.pdf).

better value for money and innovate or risk losing contracts or market share, competition can play a key role in promoting efficiency and innovation in the delivery of public services, which, in turn, can result in increased economic growth and greater prosperity.<sup>41</sup> A failure to recognise and promote competition properly can lead to less open markets, lost dynamic efficiencies and reduced incentives on suppliers to innovate and achieve value for money. Lower levels of competition in commissioning and procurement could be associated with:

- **inefficiency and a lack of innovation:** if suppliers do not face incentives to innovate or make efficiency savings, either due to a lack of effective rivalry or poorly designed contracts, then there will be little or no pressure to improve the quality of public services provided, or to deliver them in more effective ways, and
- **incumbency advantages limiting the dynamism of services:** barriers to participation for some, often newer and smaller, suppliers create a risk that contracts will always be awarded to the same few suppliers, who in turn will not face sufficient competitive constraints and incentives to improve their offerings.

## Conclusion

3.15 Within public services markets, there are a number of different models of delivery provision. In some models, there is only a sole supplier of public services, whereas in other models there are multiple suppliers (both from the public sector, private and third sectors). The ability of end users to exercise effective choice varies across public services delivery models.

3.16 Whichever delivery model is chosen, competition can be a key means of achieving greater efficiencies in commissioning and procurement practices and processes. By creating dynamic markets in which end

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<sup>41</sup> For more details on the role competition can play in improving productivity and promoting growth see *Productivity and competition: an OFT perspective on the productivity debate*, [www.offt.gov.uk/shared\\_offt/economic\\_research/offt887.pdf](http://www.offt.gov.uk/shared_offt/economic_research/offt887.pdf).

users can drive effective competition and suppliers face appropriate, aligned incentives to offer better value for money and innovate or risk losing contracts or market share, competition can play a key role in promoting efficiency and innovation in the delivery of public services, which, in turn, can result in increased economic growth and greater prosperity.

- 3.17 The following chapters, on the basis of detailed, empirical research, set out detailed and constructive guidance in order that commissioners and procurers are better equipped to leverage competition to create open and contestable public services markets to incentivise suppliers to increase efficiency, improve quality of service provision and innovate.

## 4 BARRIERS TO ENTRY

### Key points:

- Entry into a market by new suppliers, or the threat of entry, can provide strong signals to incumbent suppliers to make efficiency savings, improve quality and innovate or face losing market share. The way commissioning and procurement policies and processes are implemented can affect barriers to entry, either raising or lowering them.
- The design of bidding processes can impact on the ability and willingness of supplies to enter public services markets. For example, overly bureaucratic tender requirements can impose additional costs on potential entrants and reduce the number and diversity of bidders.
- Bidding processes that aggregate or bundle together multiple services have the potential to exploit economies of scale and scope resulting in better value for money. However, bundling together services may limit the potential number of suppliers and adversely affect market outcomes.
- Joint purchasing projects can achieve buyer power and drive down costs. Nonetheless, this can have the effect of excluding some new and/or smaller suppliers from larger procurement exercises who do not have the capacity to supply these volumes, but could offer better value for money if contracts to be awarded were smaller.
- Greater use of consortia and more diverse supply chains (using a prime and sub-contractor model<sup>42</sup>) offer the potential for increased participation in public service markets by SMEs and third sector suppliers, but such suppliers may find it hard to form consortia or take

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<sup>42</sup> A 'prime' contractor is typically a large firm with which the public body has directly contracted to provide a public service. The prime contractor may, in turn, enter into contractual relationships with smaller suppliers ('subs') to provide specialised services. The prime contractor is ultimately responsible for public service delivery.

part in more complex supply chains on an equal footing with larger, prime contractors.

- Output based contracts can stimulate innovation, but can potentially entail a greater transfer of risk that may deter entry for some new and/or smaller suppliers.
- Framework agreements have a number of advantages such as reducing administrative costs. However, they can raise unnecessary barriers to entry if commissioners and procurers are unable to add new, potentially more innovative, suppliers during the life of the framework.

4.1 Barriers to entry are a natural feature of some markets, for example, where economies of scale are very significant. In other markets, barriers to entry can be created, or exacerbated, by the behaviour of incumbent suppliers. If suppliers face significant difficulties in entering and supplying public services, incumbent suppliers will not face the threat of new suppliers challenging them for business (through winning tenders and market share) and those incumbent suppliers will have less incentive to reduce costs, innovate and price competitively. Ultimately this will make it harder for commissioners and procurers to achieve enduring value for money in public services.

4.2 To some extent, larger suppliers within the private sector have a number of natural advantages over smaller suppliers (either in the private or third sectors). These will be due to their size and can include cheaper access to finance, greater potential to exploit economies of scale and scope and greater ability to pool risks. Similarly, in a number of public services markets, the public sector in-house supplier will have a number of advantages over private and third sector suppliers, such as a track record of service provision and, in some cases, better access to information.

4.3 However, the aim of Government commissioning and procurement processes and policies should be to encourage the widest possible participation to ensure effective competition. The optimal size of

suppliers should emerge from competition and not be imposed on the market by administrative processes.

4.4 We have identified five relevant areas where there are particular risks of barriers to entry being created or enhanced in public services markets:

- the design and implementation of commissioning and procurement policies and processes
- the way in which contracts are aggregated or bundled together to provide multiple services
- the use of joint procurement projects by commissioners and procurers in different institutions
- the promotion, by commissioners and procurers, of new delivery models and contract types, and
- the use of framework agreements by the public sector.

### **The design and implementation of commissioning and procurement policies and processes**

4.5 Tendering processes for public sector contracts to supply can be thought of as forms of auctions, with the winner being measured on more criteria than simply price. There is a vast academic and empirical literature on auction design, highlighting the potential benefits of well designed bidding processes as well as the pitfalls, in terms of entry deterrence and collusion, of badly designed ones<sup>43</sup>. Long and complex bidding processes can create entry barriers by increasing the costs of entering public markets (through entering bidding competitions) and disproportionately favouring large suppliers and incumbents that will typically have more resource to devote to the bidding process.

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<sup>43</sup> See for example Klemperer (2003).

4.6 Factors that can contribute to exacerbating barriers to entry in the design and implementation of commissioning and procurement policies and processes in public services markets can include:

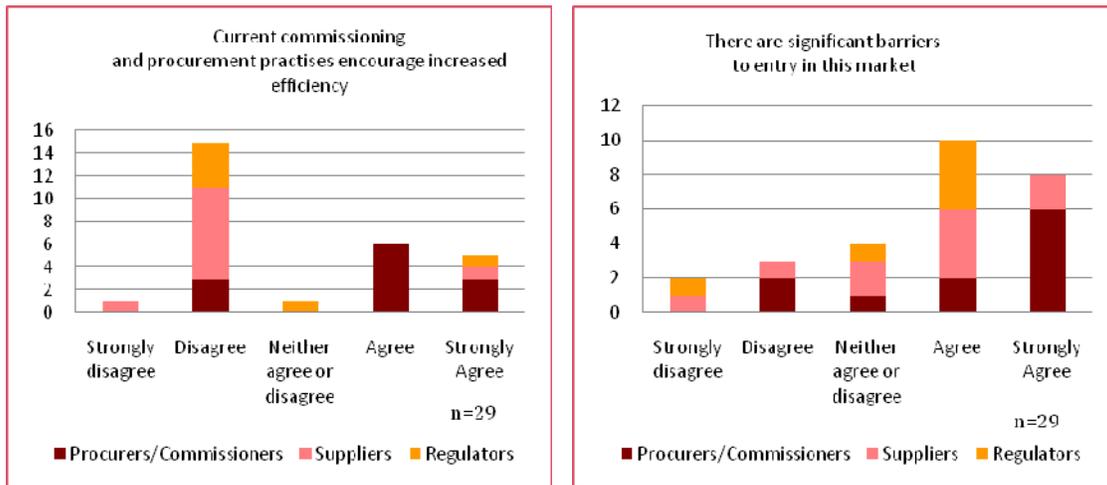
- **overly long and non-standardised PQQs:** smaller suppliers may be dissuaded from bidding if the length of time and cost involved in completing PQQs is significant and different for each tender,<sup>44</sup> especially if the chances of success are highly uncertain
- **the frequency of tendering:** if the length of contracts is short and re-tendering is a frequent occurrence, some suppliers may not have sufficient time to recover costs and thus face a barrier to entry (this will also increase bidding costs), but equally overly long contracts can make it harder for some unsuccessful bidders to stay in the market if these contracts are only rarely put out to market, especially when the public sector constitutes a significant buyer in the market
- **requirements to have an extensive track record:** tender requirements that seek multiple examples of past experience and references can deter potential new entrants who have no track record but an innovative approach, and risk entrenching incumbency advantages enjoyed by either the in-house supplier or existing private or third sector providers, and
- **high financial turnover and indemnity insurance thresholds:** as is discussed in more detail in Chapter 5, requirements to protect end users from the risk of supplier failure can favour in-house suppliers or larger suppliers in the private sector with more experience and capital.

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<sup>44</sup> However, it should be noted that fully standardised PQQs may also constraint the ability of some suppliers to demonstrate a particularly new and innovative business model if the standardised form does not allow for alternative specifications. It may be appropriate to retain a degree of flexibility in PQQs.

4.7 As part of its interview process, PwC conducted a 'mini-survey' to capture the opinions of wide range of participants' relating to commissioning and procurement processes.<sup>45</sup> Figure 4.1 shows that the majority of suppliers disagreed with the contention that current practices encouraged increased efficiency and two-thirds of all respondents (suppliers, commissioners and procurers) agreed or strongly agreed that there are significant barriers to entry into public sector markets.<sup>46</sup>

**Figure 4.1: Views on commissioning and procurement practices from six case studies**



Source: PwC

<sup>45</sup> This was carried out during January 2010 and consisted of a set of short interviews with 31 commissioners, procurers, suppliers and regulators. While this survey was not intended to achieve statistical significance, it did allow the OFT and PwC to explore the drivers of behaviour across the wider public sector commissioning and procurement landscape.

<sup>46</sup> The percentages for each of the groups reflected the overall average with 75 per cent of procurers, 60 per cent of suppliers and 67 per cent of regulators sharing this view. A review of comments made by SMEs and other suppliers to the No.10 website's procurement page cites similar observations that PQOs, rigid experience requirements, the size and complexity of contracts and inappropriate bundling can all contribute towards limiting the ability of all potential bidders to win a contract. See [www.number10.gov.uk/problemwithprocurement](http://www.number10.gov.uk/problemwithprocurement) for further details.

4.8 The cause of overly long and bureaucratic procurement processes does not appear to be existing EC public procurement regulations. These do not themselves limit the ability of commissioners and procurers to be innovative in how they purchase goods and services and promote competition. However, evidence received<sup>47</sup> from commissioners and suppliers has suggested that guidelines, which are often issued by local and central government, lead to processes which are excessively prescriptive and which lead to risk-averse interpretations of regulations. Similar 'gold plating' can lead to an overly bureaucratic process, creating excessive costs for potential suppliers and reluctance by procurers to engage with potential suppliers prior to going to out to tender which, in turn, can lead to badly specified tender documents.

**Box 4.1: Procurement process in prisons and pensions**

Our case study on prisons procurement highlighted concerns that tightly specified tenders reduce the scope for the proposal of alternative, more innovative, delivery models. Suppliers said they completed bid documents with a view to passing through various procurement hurdles, which was not always perceived as the same as writing a bid demonstrating their understanding of what commissioners were looking for.

In contrast, our case study on pension scheme administrative services for NEST (PADA) demonstrated an example of commissioners and procurers allowing sufficient flexibility in the bidding process, through early and close engagement with bidders, helping both suppliers and PADA to get a proper understanding of what the requirements were, and who was best placed to meet them.

4.9 Tender specifications that place a high weighting on price as compared to other value for money factors, such as quality, may also make it harder for some suppliers to enter public services markets. Evidence received from some suppliers suggested that commissioners and

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<sup>47</sup> As part of the OFT's discussions.

procurers, in some cases, failed to give due consideration (and weighting) to non-price factors, instead always focusing on price, which may not represent good value for money in the long-run.

4.10 The OFT notes that ERG is currently looking to ways to address existing ineffective procurement processes<sup>48</sup>. Our analysis would suggest that there remains further scope for processes to be streamlined, at both central and local levels of commissioning and procurement. In particular, there appears scope for greater use of:

- **Electronic invoicing (e-invoicing):** utilising electronic invoicing over traditional paper and postage format can offer savings in printing and postage costs, but most importantly it potentially offers savings through process automation and the ability to duplicate and generate invoices automatically through a supply chain which can lead to quicker payments,<sup>49</sup> and
- **Dynamic purchasing systems (DPS)** – these are electronic systems of limited duration that can be used by a contracting authority to purchase commonly used good and services. Suppliers interested in being admitted to a DPS set out 'indicative tenders' specifying the terms under which they would be willing to enter a contract. A DPS can be useful as a streamlined way for procurers to make 'off the shelf' purchases competitively.

**Key insights:**

- **Where possible, complex procurement policies and processes should be streamlined and consideration should be given not to go beyond the minimum required under EC regulation in order to reduce barriers to entry to public services markets.**

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<sup>48</sup> See Annexe B for further details.

<sup>49</sup> E-invoicing can also reduce entry barriers by speeding up the process of invoice payment, thereby reducing cashflow shortages - see the section below on risk on for more details.

- **Commissioners and procurers should consider using new electronic based tools as a potentially effective way to increase participation.**

4.11 Where possible, complex procurement policies and processes should be streamlined and consideration should be given not to go beyond the minimum required under EC regulation in order to reduce barriers to entry to public services markets.

## **Contract aggregation**

4.12 Where economies of scale and scope exist for aggregating or 'bundling' tender contracts for different public services these can create significant efficiencies and lead to better value for money. Efficiencies can also arise from reducing administrative and transaction costs for procurers and suppliers can reduce costs by spreading overheads over larger contracts.

4.13 In some public services markets, the efficiency benefits of contract aggregation are clear. However, these efficiencies have to be weighed against potential competition concerns. The National Audit Office (NAO) has noted that the aggregation or bundling of contracts can act as a barrier to entry for smaller suppliers as they will not have the capacity or capability to deliver the aggregated output,<sup>50</sup> even if they have the ability to supply individual components at potentially better value for money. Dynamically, this may result in these suppliers exiting or not entering the market and this innovative capacity being lost.

4.14 When deciding whether to bundle contracts, it is also important that commissioners and procurers have an appreciation of the nature of the product that is being purchased and the available markets. Some public services may be more suitable than others for aggregation. Services

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<sup>50</sup> See NAO, *A review of collaborative procurement across the public sector: public and private sector case studies*, [www.nao.org.uk/idoc.ashx?docId=01e137a4-551e-4f48-95d0-00f7434705a9&version=-1](http://www.nao.org.uk/idoc.ashx?docId=01e137a4-551e-4f48-95d0-00f7434705a9&version=-1) or Nalebuff (2003), Report for DTI, *Bundling, Tying and Portfolio Effects*, [www.bis.gov.uk/files/file14774.pdf](http://www.bis.gov.uk/files/file14774.pdf).

more suitable for aggregation may include those that exhibit strong economies of scale and scope, where there is no large existing incumbent and the service can be readily commoditised. Our case study on PADA found that the unbundling of different components allowed the procurement team to 'cast their net significantly more widely, introducing more appropriate potential suppliers and more competition'.

**Key insight:**

- **In the absence of significant, countervailing economies of scale and scope, consideration should be given to disaggregating contracts for different services to encourage the widest possible range of suppliers.**

## **Joint procurement**

4.15 Joint purchasing in the public sector involves two or more groups of commissioners and procurers in different institutions combining their commissioning and procurement activities either for a one-off procurement exercise in a particular market or for a longer period across many markets. As set out in the OFT's Government in markets paper<sup>51</sup>, there are a number of benefits to joint purchasing. These include:

- being able to aggregate demand to achieve better deals with suppliers (buyer power)
- freeing up resources to focus more closely on delivering core functions
- pooling together resources to attract high quality commissioning and procurement staff
- greater attention to contracts and contract management by staff who are able to better understand the market and their suppliers

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<sup>51</sup> See *Government in markets: why competition matters – a guide for policy makers*, [www.of.gov.uk/shared\\_of/business\\_leaflets/general/OFT1113.pdf](http://www.of.gov.uk/shared_of/business_leaflets/general/OFT1113.pdf).

- facilitating greater strategic thinking over the long-term development of the market
- providing volume and predictability to suppliers, thus enabling them to make long-term investments and to innovate, and
- minimising duplication between procurers (both within institutions and between institutions).

4.16 A recent example of the benefits of buyer power not being captured in the public sector was highlighted by the NAO in the healthcare sector.<sup>52</sup> The NAO reported that 'at least 10 per cent of hospitals' spending on consumables, amounting to some £500 million a year, could be saved if Trusts got together to buy products in a more collaborative way. Frequent small orders, buying too many types of the same product (21 types of A4 paper), all contribute to hospitals not getting value for money and overspending.'

4.17 Joint purchasing has recently been advocated in the Green Review<sup>53</sup> which found central government was often purchasing the same goods and services at vastly different prices, and could significantly reduce costs by centralising the procurement of commodities and using volume to drive down prices. A recent example of similar, local joint procurement is the case of the two London Authorities of Bromley and Lewisham jointly purchasing ICT services of the same specification from a single supplier, reporting savings of up to £2 million combined.<sup>54</sup>

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<sup>52</sup> See *The procurement of consumables by NHS acute and Foundation trusts*, February 2011, [www.nao.org.uk/publications/1011/nhs\\_procurement.aspx](http://www.nao.org.uk/publications/1011/nhs_procurement.aspx).

<sup>53</sup> *Efficiency Review by Philip Green – Key findings and recommendations* <http://download.cabinetoffice.gov.uk/efficiency/sirphilipgreenreview.pdf>.

<sup>54</sup> See [www.lewisham.gov.uk/NewsAndEvents/News/CouncilsInnovativeJoint+ICTProcurementSavesMillions.htm](http://www.lewisham.gov.uk/NewsAndEvents/News/CouncilsInnovativeJoint+ICTProcurementSavesMillions.htm).

- 4.18 However, if such exercises are done without a clear understanding of the market, joint procurement can act as a barrier to entry for certain types of suppliers. Potentially there can be adverse effects, including:
- through having larger contracts or aggregating services, joint purchasing organisations can make it hard for smaller suppliers to provide the required volumes
  - joint purchasing organisations in the public sector, may crowd out private and third sector suppliers due to their size and through any incumbency advantage, and
  - by involving larger contracts, joint purchasing could lead to an associated push towards standardisation in specified goods and services by the joint purchasing organisation across large geographical areas, which reduces incentives to innovate and tailor services to local markets and individual users.
- 4.19 These issues are particularly pertinent for local authorities who often face in procurement decisions balancing complex trade-offs between the scale benefits of joint procurement and other objectives, including localism<sup>55</sup> and the involvement of SMEs. It is often not feasible for smaller, local suppliers to supply the volumes required on large, joint contracts.

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<sup>55</sup> Localism can be broadly defined as a range of policies that seek to favour local production and consumption of goods and services. In the context of the Government's Localism Bill it refers to moves to increase decentralise power and diversify the supply of public services. For more details see [www.communities.gov.uk/documents/localgovernment/pdf/1793908.pdf](http://www.communities.gov.uk/documents/localgovernment/pdf/1793908.pdf).

**Box 4.2: Joint procurement by Public Sector Buying Organisations on behalf of schools**

After local authorities were permitted to provide goods and services to other public sector organisations, local authority store operations began to merge into public sector buying organisations (PSBOs).

The intention of local authorities was for these PSBOs to be able to exert effective buyer power and achieve cost savings on behalf of schools, which individually had very fragmented demand. However, our case study in this area revealed that in some cases, private sector organisations have found it hard to penetrate these markets due to incumbency advantages enjoyed by PSBOs. Schools were reported as being reluctant to consider alternative organisations, regarding local PSBOs as 'benevolent extensions of the local authority'. This can have the effect of leading to PSBOs not being driven to the same efficiencies as private sector suppliers.

- 4.20 As the above example illustrates, as well as ensuring a level playing field between different types of suppliers within the private and third sectors, commissioners and procurers need to consider whether suppliers in the private and third sectors can effectively rival the public sector in-house supplier – that is ensuring a level playing field between all suppliers, regardless of which sector they come from (this is known as 'competitive neutrality').<sup>56</sup> This is especially important in mixed markets where the private and third sector competes alongside public sector in-house suppliers of public services. If the private sector is crowded out by the public sector in-house supplier's incumbency advantage, this may lead to reduced overall capacity in the market and reduced competitive constraints on the public sector in-house supplier incumbent to improve efficiency, quality and innovate.

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<sup>56</sup> See OFT 2010: *Government in Mixed Markets: Ensuring Competitive Neutrality*, [www.of.gov.uk/shared\\_of/economic\\_research/oft1242.pdf](http://www.of.gov.uk/shared_of/economic_research/oft1242.pdf).

**Key insight:**

- **Joint purchasing projects by commissioners and procurers in multiple public sector agencies to achieve buyer power should take into account the potential impact on smaller suppliers on taking part in larger scale procurement exercises.**
- **Where possible, public agencies should consider dividing contracts into lots to facilitate entry and maximise the benefits of competition.**

**New delivery models**

- 4.21 One mechanism to preserve competition while achieving benefits from contract aggregation and joint procurement is to encourage suppliers such as SMEs and those in the third-sector to form consortia (either between themselves or with larger private sector suppliers) or to participate at in a larger supply chain through 'prime-sub' relationships.
- 4.22 Procuring from consortia can be a useful way in which commissioners and procurers can help new and/or smaller suppliers overcome the potential barriers to entry that can be erected through aggregating contracts and joint procurement. These suppliers can form, or become part of, larger consortia that have greater ability to bid for larger contracts.
- 4.23 Our conversations with existing and potential suppliers and industry associations suggests that while there has been much rhetoric about the opportunities available for, and benefits associated with, consortia, in practice there are multiple logistical barriers that exist preventing such opportunities from becoming a reality. Such barriers include some SMEs' and third sector suppliers' lack of knowledge on how to draft contracts and other legal agreements to establish a consortium and the increased bureaucracy that comes with a consortium.
- 4.24 In addition, it has been suggested by suppliers that procurers can still exhibit risk aversion to consortia comprising solely of SMEs or charities and that tender requirements can, in some cases, appear to discriminate

against such consortia. Moreover, there were suggestions that public sector contracts had become so large, both in scale and scope, that even the formation of consortia of a sufficient scale was beyond many SMEs and charities.

4.25 Suppliers, such as SMEs and third sector providers, can also participate in public services markets through taking part in supply chains where a larger supplier is the prime contractor. Smaller suppliers can enter into sub-contractual relationships (as subs) with these larger suppliers (as primes) who are responsible for managing all aspects of the contract and interfacing with procurers and contract managers in the contracting public sector organisation. As noted in the Merlin Standard<sup>57</sup> on supply chain excellence (see Box 4.4), having a successful supply chain can promote innovation and allow best practice to be shared across suppliers. Thus, preserving competition down the supply chain and ensuring sub-contractors are able to effectively contract with prime-contractors on an equal footing is important to maintaining long-term sustainable and flexible markets.

4.26 It has been suggested to us by some industry associations that in practice, smaller suppliers acting as subs often have unequal bargaining power vis-à-vis primes leading to:

- the prime transferring a disproportionate amount of risk onto the sub, even though the prime is ultimately responsible for public service delivery
- insisting on a payment schedule where the sub is paid last and only once other expenses have been paid, leading to cashflow problems for subs
- appropriating subs' intellectual property and using this on subsequent contracts without involving them.

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<sup>57</sup> Available at [www.dwp.gov.uk/docs/sub-contracting-merlin-standard.pdf](http://www.dwp.gov.uk/docs/sub-contracting-merlin-standard.pdf).

- 4.27 It has also been reported to the OFT by supplier associations of instances where primes have insisted on an exclusive relationship with subs making it harder for the sub to work with other primes in other parts of the country, even if the prime requiring the exclusive relationship does not operate in that geographical market. In entering into a prime-sub relationship, subs also risk being taken over and the prime acquiring their expertise, though in some cases there can be efficiency benefits associated with vertical integration.

**Box 4.3: Prime-sub contractor issues in the Flexible New Deal**

Our case study on the Flexible New Deal reported that the DWP was motivated to move towards contracting with a small number of prime contractors which, in turn, would sub-contract with other suppliers for the performance of certain elements of the contract.

A number of issues were highlighted, however, with regard to using a prime/sub model across the supply-chain. Despite DWP's desire for mixed delivery provision with SMEs and third sector providers working with larger suppliers, some larger suppliers, acting as primes, have taken to supplying all services across the supply chain rather than involving smaller suppliers as sub-contractors.

Concerns have also been raised about larger suppliers, acting as prime-contractors, limiting the ability of subs to bid with multiple primes. Our case study reported one sub bidding with two different primes who both won contracts in the same area (more than one prime could win each area in order to promote competition in the market). It was subsequently agreed that it would be best if the sub only worked with one of the primes concerned. While in this case it was reportedly due to the administrative difficulties that working with two primes in the same area could cause, it nevertheless left a potential concern about primes influencing who subs can work with.

- 4.28 The Government's Merlin Standard has begun to address some of these issues with the DWP. The Merlin Standard was designed by DWP with providers and representative bodies involved in Welfare to Work services

to help promote high performing supply chains and positive behaviours and relationships in the delivery of provision of these public services.

**Box 4.4: The Merlin Standard**

The Merlin Standard has been designed to recognise and promote sustainable excellence and positive partnership working within supply chains and provide guidance to those seeking to achieve it. It is built upon four integrated principles: supply chain design, commitment, conduct and review.

Under each of these principles, managers of supply chains are provided with a series of 'elements' that allow them to carry out an assessment of each potential supplier's supply chain to identify areas of best practice and improvement.

The Merlin Standard is designed to assess at 3 levels:

- **prime contractor ('prime')** – by confirming compliance to the Standard, identifying best practice and gaining feedback on Commissioning activity
- **supply chain partners** – by confirming the behaviour of primes against the Standard, identifying and confirming best practice and identifying any commissioning activity that affects supply chain behaviour, and
- **commissioning** – identifying impacts on supply chain behaviour resulting from contract design and procurement activity.

More details can be found at [www.dwp.gov.uk/docs/merlin-standard.pdf](http://www.dwp.gov.uk/docs/merlin-standard.pdf).

- 4.29 The Merlin Standard appears to have gone some way towards meeting the concerns of smaller third sector organisations that had previously contracted directly with DWP. There would appear to be scope for the standard to be both rolled out across other government departments and strengthened to ensure the competition concerns outlined above are effectively addressed.

**Key insight:**

- **The involvement of SMEs and third-sector suppliers in consortia and supply-chains can widen the supplier base and increase the scope for innovation. It is important, therefore, when designing and specifying new delivery models, that commissioners and procurers ensure that suppliers are still incentivised to innovate and that sub-contractors are able to negotiate contractual terms with prime-contractors on an equal footing.**
- **Greater use, and strengthening, of the Merlin Standard is a potentially effective route to achieve this.**

**The transfer of risk**

4.30 As public services are increasingly delivered by the private sector and third sector, suppliers in these sectors will need to be incentivised to continue to make efficiency savings and innovate. One mechanism to create such enduring incentives is to pay suppliers only on successful completion of pre-specified outputs or outcomes. Incentives are created through the payment being agreed and fixed at the start of the contract, meaning that if the supplier is able to deliver the output or outcome more cheaply during the life of the contract, by making efficiency savings or using a more innovative delivery model, they will be able to achieve greater returns over the life of the contract. Such contracts are often known as 'payment by results' or 'payment by outcome' contracts.<sup>58</sup>

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<sup>58</sup> Payment by results contracts have been discussed extensively elsewhere, for example in a recent report by the 2020 Public Services Trust (Payment by Outcome: a Commissioner's Toolkit available at [www.serco.com/Images/Payment%20by%20Outcome%20\(web%20version\)\\_tcm3-36967.pdf](http://www.serco.com/Images/Payment%20by%20Outcome%20(web%20version)_tcm3-36967.pdf)). The focus of this study is to explore how such contracts may affect barriers to entry into public services markets.

#### **Box 4.5: Payment by results**

Payment by results contracts are those by which suppliers are paid based on their achieving pre-determined success criteria. Several Government departments responsible for public service provision have announced that they are moving to payment by results, including prisoner rehabilitation services and welfare-to-work services (see for example [www.dwp.gov.uk/newsroom/press-releases/2010/dec-2010/dwp184-10-221210.shtml](http://www.dwp.gov.uk/newsroom/press-releases/2010/dec-2010/dwp184-10-221210.shtml)). The rationale behind payment by results is that it aligns the incentives of the supplier with the desired outcomes of the commissioner by directly linking payment to meeting these outcomes.

- 4.31 The increased use of the 'payment of results' mechanism has the potential to improve supplier incentives as long as outputs can be, and are, clearly specified and understood. However, it also has the potential to raise barriers to entry<sup>59</sup> for those suppliers who are unable to maintain their cashflow in the absence of a steady or uncertain income stream. Our case study examining the Flexible New Deal showed that while a move to outcome based contracts is welcomed by many SMEs and third-sector suppliers, there are concerns on the impact the 'payment by results' mechanism may have on their cash-flow. In particular, SMEs and third-sector suppliers do not have, or are unable to access capital in the interim to maintain cash-flow, limiting their ability to compete with larger suppliers for these contracts is restricted.
- 4.32 Similarly, if implemented without considering wider objectives and the nature of competition, these mechanisms could distort suppliers' incentives and lead to unintended consequences. For example, payment by result contracts could be gamed with suppliers focusing on 'easy wins' or 'cream skimming' by concentrating on finding 'cheaper to serve' customers rather than delivering services comprehensively. Our international case study on welfare to work found that there had been evidence of such 'gaming' in Australia by suppliers, such as putting

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<sup>59</sup> The effect of such payment methods on suppliers' incentives is discussed in Chapter 7.

different customers through the same job to secure outcome payments and concentrating on finding jobs for those easiest to place back in work rather than the hardest customers.

4.33 In our discussions with suppliers in the context of this study, we have also been made aware of other transfers of risk from the public sector to the private sector or third sector that may constitute additional barriers to entry to certain types of suppliers in public services markets, such as:

- the transfer of pension liabilities
- the transfer of undertakings on protection of employment (TUPE), and
- liability for health and safety.

4.34 As these liabilities are transferred to the private and third sector from the public sector, they can raise these suppliers' costs and lead to bids from the private and third sector appearing more expensive than in-house supply. This may lead to procurers favouring in-house supply, where because such liabilities do not need to be transferred as part of the procurement exercise these costs are effectively hidden, causing the in-house supplier to be chosen even when it does not offer the best value for money. Suppliers responding to our case study on prisons argued that public sector in-house provider(s) in relation to prisons procurement did not have to account fully for pay and pensions, insurance and central overheads, making the option of public sector in-house provision appear cheaper than it actually was.

**Key insights:**

- **The use of outcome based contracts can create incentives to innovate. However, these should be designed in a way so as not to dissuade entry by new and/or smaller suppliers who are less able to access up-front finance.**
- **When comparing private and third sector bids with public sector in-house provision, in order to generate genuine competition, the cost of liabilities such as pensions and health and safety should be factored in by**

commissioners and procurers when assessing public sector in-house bids so as to ensure they are appropriately evaluated and there is a level playing field between all suppliers.

## Framework agreements

- 4.35 Framework contracts or agreements are general terms for an arrangement with a named group of suppliers which set out terms and conditions under which specific purchases ('call-offs') can be made throughout the duration of the agreement's term. Some frameworks are divided into 'lots' for particular services.<sup>60</sup>
- 4.36 A framework contract allows procurers to source public services at short notice without having to go through a full-tender process. There may be significant efficiency savings available to procurers from choosing a framework mechanism, especially if there is repeat procurement, through reduced administrative and time costs.
- 4.37 While there are a number of benefits from using a framework contract, our discussions with procurers and suppliers in the context of this study have noted a number of potential risks around their use. Namely:
- **locking out potential new suppliers:** many framework contracts were 'closed', meaning that once they have been established, any new entrant, who may offer more efficient, innovative, services did not have the opportunity to supply
  - **the potential for collusion:** by restricting the number of firms that can win contracts, and reducing the criteria on which they will be judged, it may be easier for listed suppliers to coordinate their bids

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<sup>60</sup> For an example of guidance on Framework Agreements see *OGC Guidance on Framework Agreements in the Procurement Regulations*, [www.ogc.gov.uk/documents/OGC\\_Guidance\\_on\\_Framework\\_AgreementsSept\\_08.pdf](http://www.ogc.gov.uk/documents/OGC_Guidance_on_Framework_AgreementsSept_08.pdf).

- **the reduction of suppliers on a framework:** if suppliers on a framework exited the market through merger, this would reduce the number of suppliers on a framework and potentially reduce the (non-price) competition faced by the remaining suppliers, and
- **the limited use of frameworks:** the cost involved in bidding to join a framework can be significant for private and third sector suppliers – however, if they perceive there is little prospective of suppliers actually being invited to bid for service contracts once they have become of a framework, this can dissuade suppliers from bidding in the first place to become part of the framework as they will not have the opportunity to be able to recover the costs of bidding through winning contracts.

4.38 The potential adverse impact on competition resulting from poorly designed framework contracts was seen recently in the healthcare sector.<sup>61</sup>

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<sup>61</sup> See [www.ccpnel.org.uk/content/cases/North-West-Specialist-Commissioning-Team-conduct-complaint/Press\\_notice\\_not\\_embargoed.pdf](http://www.ccpnel.org.uk/content/cases/North-West-Specialist-Commissioning-Team-conduct-complaint/Press_notice_not_embargoed.pdf) for further details. The Principles and Rules establishing a system of rules governing cooperation and competition in the commissioning and provision of NHS services in England that are referred inn Box 4.5 can found at [www.dh.gov.uk/en/Publicationsandstatistics/Publications/PublicationsPolicyAndGuidance/DH\\_113746](http://www.dh.gov.uk/en/Publicationsandstatistics/Publications/PublicationsPolicyAndGuidance/DH_113746)

**Box 4.6: Cooperation and Competition Panel finds against Framework Agreements used by North West Specialised Commissioning Group**

In November 2010, following a complaint by Hanover Healthcare, The Cooperation and Competition Panel (CCP) found that North West Specialised Commissioning Group's (NWSCG) use of long term exclusive Framework Agreements for secure mental health services breached the Principles and Rules for Cooperation and Competition.

The CCP found that, under the circumstances, the 4-year exclusive framework agreements were likely to impose costs on patients and taxpayers by restricting the ability of the NSWCG to take advantage of offers by providers not within the Framework Agreement, by restricting competition between competitors on the Framework Agreement by using rankings awarded at the time of the tender rather than using mini-competitions between suppliers appointed to the Framework Agreement and by discouraging investment by providers not on the Framework Agreement in secure mental health services in the North West that would benefit patients and taxpayers.. The CCP found that, in this case, the countervailing benefits associated with framework agreements of increased bargaining power and reduced administrative costs were small, and therefore concluded that the Framework Agreement breached the Principles and Rules. The CCP later decided to recommend remedies, which included requiring NSWCG to use providers whether or not they were on the Framework Agreement, to no longer implement long-term exclusive Framework Agreements, and to publish on its website details of mental health services contracts it had entered into with suppliers.

**Key insight:**

- **Framework agreements should be designed to allow additional suppliers to be added during the life of the framework mechanism, if these suppliers can demonstrate they meet the same objective criteria used to select existing suppliers within the framework.**

## 5 BARRIERS TO EXIT

### Key insights:

- The existence of barriers to exit enable inefficient incumbents to remain in the market, dampening competitive constraints and exacerbating entry barriers for more efficient suppliers.
- In public services markets with little or no history of private or third sector provision, there may be a limited number of potential suppliers. If the public service in question must be continuously supplied without any gaps in provision, then any requirements on potential suppliers to ensure a continuity of supply should take account of market conditions and their ability to make contingency arrangements to ensure the service is provided in the event of their exit or failure.
- The costs of ensuring continuity of supply should not only be evaluated when assessing private and third sector bids. In evaluating public sector in-house supply options, the cost of failure of public sector suppliers should be accounted for appropriately, and in a consistent manner, to avoid always favouring in-house suppliers, even when they do not represent optimal value for money.
- In public services markets with a history of private and third sector involvement, there are likely to be larger and more diverse supplier bases. In such cases, commissioners and procurers should ensure that contracts with suppliers allow the public sector to switch effectively and swiftly to more efficient suppliers in the event of poor performance.
- The criteria applied by commissioners and procurers for judging contract performance should be as clear and objective as possible so as not to dissuade market entry by new suppliers and avoid lengthy and costly disputes between suppliers and contract managers arising from early contract termination.

- 5.1 Barriers to exit arise when there are obstacles to existing suppliers leaving a market. They can arise through regulatory and contractual

arrangements that prevent swift exit by incumbent suppliers or if suppliers cannot easily recover investments when exiting. If significant barriers to exit exist in a market then this may have the effect of allowing inefficient suppliers to remain in the market. One consequence of this may be that more efficient suppliers, instead of undercutting inefficient rivals' prices or offering higher quality in order to gain market share, find it more profitable to engage in less aggressive rivalry leading to higher prices and lower quality. The presence of significant barriers to exit may also dissuade entry by more efficient suppliers in the first instance if they perceive they will not be able to exit and recover their investment if they are unable to establish themselves successfully.

- 5.2 In public services markets with little or no history of private or third sector provision, there may be a limited number of potential suppliers, meaning commissioners and procurers may face significant challenges in ensuring continuity of supply if there are no existing, appropriate replacements for exiting suppliers. This may lead to Government taking active measures to prevent suppliers from exiting the market or requiring suppliers setting out in bid materials what contingency arrangements they will put in place to maintain supply in the event of exit. In the former case, this may weaken incentives on suppliers to perform well, if they know they will not be replaced by more efficient rivals. In the latter case, this may raise the costs of bidding, making it harder for some suppliers to bid for public contracts.
- 5.3 In public services markets with a history of private and third sector involvement, there are likely to be larger and more diverse supplier bases. Here, commissioners and procurers will need to ensure that they leverage the threat of switching and design appropriate incentives for suppliers to be motivated to improve their offering. If there are high switching costs, then Government may be reluctant to replace even poorly performing suppliers with potentially more efficient ones.
- 5.4 However, a balance needs to be achieved by commissioners and procurers when designing contracts. New suppliers may be deterred from tendering to supply a public service market if they are concerned that the contract, once awarded, could then be arbitrarily terminated by

the public sector. One way to achieve this balance is to work with potential suppliers in advance of any tender to ensure there are clear and objective performance targets in advance that can be clearly linked to suppliers' performance.

## **Continuity of supply**

- 5.5 In many public services markets, such as healthcare, education and welfare, there needs to be continuous provision of service<sup>62</sup>. Any break in provision of service through a supplier exiting the market either by mutual consent, business failure or being acquired by another firm can have major consequences for end users. This was a key concern in our adult residential care homes case study, with interviewees highlighting the critical need to have a strategy to ensure continuity of supply in the event of a large supplier exiting the market.
- 5.6 In public services markets with little or no history of private or third sector provision or where the service is highly specialised or contract sizes are large, there may be a limited number of potential suppliers. In such circumstances, commissioners and procurers will have three broad options with respect to ensuring continuity of supply:
- replace the existing supplier with a public sector in-house supplier
  - support the failing supplier to continue providing public services, and
  - enact any viable contingency arrangements.
- 5.7 In this context, there are many examples of commissioners and procurers of public services having to replace poorly performing or failing private or third sector suppliers with in-house provision. For example, in 2000, Lambeth council spent £1.5 million to take over the provision of

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<sup>62</sup> Although, it should be noted that ensuring continuity of supply is not just important in public services markets. Many private sector supply chains also require there to be a continuous provision of service.

housing benefits in the borough from a private sector contractor three years into its seven year contract. The private sector contractor had failed to clear a substantial backlog of housing benefit claims leaving some residents facing eviction.<sup>63</sup> However, while replacing an exiting supplier with an in-house supplier may be a practical and appropriate short-term measure, there may be significant adverse impacts if it leads to distortions in future commissioning and procurement decisions. The option of recourse to in-house self supply is (almost) always available. This may lead procurers always to revert to choosing the incumbent in-house supplier pre-emptively if procurers perceive there is a risk of a private or third sector supplier having to be replaced due to market exit or poor performance. If such a perception is put into practice, this will potentially create an uneven playing field between public sector in-house suppliers and those in the private and thirds sectors, as was discussed in Chapter 4.

- 5.8 There are also numerous examples of the Government or other public sector bodies stepping in to prevent suppliers from failing. For example, a joint venture between Dundee University and a private sector contractor to build a new hall of residence for students of the university failed to attract sufficient numbers of students resulting in the joint venture making losses of over £1.5 million across two years, causing the university to provide funding to the joint venture to maintain the service.<sup>64</sup> If incumbent suppliers perceive that the Government, or another public body, will intervene if there is a risk of failure and market exit by a supplier and that those suppliers are therefore effectively 'too big to fail', this can lead to a 'moral hazard' situation, resulting in weaker incentives on suppliers to perform well because there is no threat of other suppliers taking their place.

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<sup>63</sup> Quoted in *The Case for in-house services*, [www.unison.org.uk/file/The%20case%20for%20in-house%20services%20-%20a%20branch%20guide.pdf](http://www.unison.org.uk/file/The%20case%20for%20in-house%20services%20-%20a%20branch%20guide.pdf). Also see [www.guardian.co.uk/society/2001/jul/02/ppp2](http://www.guardian.co.uk/society/2001/jul/02/ppp2).

<sup>64</sup> Ibid.

- 5.9 The final option to ensure continuity of supply available to commissioners and procurers of public services relates to enacting existing contingency arrangements in suppliers' contracts to preserve continuity of supply. This option is, however, not always available. The House of Commons Public Accounts Committee found that in 2009, 56 per cent of public services contracts did not have a contingency plan in the event of supplier failure<sup>65</sup>. However, in many public services markets with large supplier bases and low switching costs, the need to have contractual contingency arrangements may be unnecessary if suppliers can be quickly and effectively replaced by alternative suppliers.
- 5.10 Contractual contingency arrangements to ensure continuity of supply can include:
- **licensing conditions:** suppliers may have clauses in their contract to ensure that, should they fail, a rival supplier can take over service provision and any intellectual property rights, capital assets and staff are transferable, and
  - **underwriting risk:** potential suppliers have to post bonds to underwrite the costs of failure.
- 5.11 We are aware that commissioners and procurers are increasingly looking for suppliers to set out contingency arrangements in bid documents. Our case study into PADA found that a particularly large weighting (10 per cent) was given by commissioners and procurers to the robustness of contingency and exit plans when evaluating bids.
- 5.12 While detailed, worked up contingency and exit plans can address concerns around continuity of supply, there is a risk that imposing such requirements can raise the cost of participation for some new and/or smaller suppliers. This may deter potential suppliers from bidding, even if

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<sup>65</sup> Quoted in *Public sector supply chain: risks, myths and opportunities* by Zurich Mutual, [www.zurich.co.uk/NR/rdonlyres/82A58CDF-D38F-414F-AC43-CB0C4CBB7CBF/0/thebriefingpaperfullversion.pdf](http://www.zurich.co.uk/NR/rdonlyres/82A58CDF-D38F-414F-AC43-CB0C4CBB7CBF/0/thebriefingpaperfullversion.pdf).

the relevant risk of failure and the probability of contingency plans being enacted are low.

- 5.13 Further, when commissioners and procurers compare these private and third sector bids with those from a public sector in-house supplier, if the cost of ensuring continuity of supply is not properly accounted for in the public sector in-house bid, there is a risk this will be chosen even when it does not offer value for money.

**Key insights:**

- **In public services markets with little or no history of private or third sector provision, there may be a limited number of potential suppliers. If the public service in question must be continuously supplied, then any requirements on potential suppliers to ensure a continuity of supply should take account of market conditions and their ability to make contingency arrangements to ensure the service is provided in the event of their exit or failure.**
- **The costs of ensuring continuity of supply should not only be evaluated for private and third sector bidders. In evaluating in-house options, the cost of failure by public sector in-house suppliers should also be accounted for to avoid always favouring in-house suppliers, even when they do not represent optimal value for money.**

## **Switching costs**

- 5.14 In mature public services markets, the level of contingency requirements may be less onerous as commissioners and procurers may be able to choose a replacement supplier from a large and diverse supplier base and switch effectively and swiftly. For example, in the education sector, following poor performance and serious delays in the marking of Sats<sup>66</sup> examination scripts in the summer of 2008, the company responsible

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<sup>66</sup> The problem related to the marking of national tests at Key Stages 2 and 3 for 11 and 14 year olds in England. See <http://news.bbc.co.uk/1/hi/education/7562835.stm> and <http://news.bbc.co.uk/1/hi/education/7805559.stm>.

had its five year contract with the Qualifications and Curriculum Authority, worth over £150 million, terminated by mutual consent and was required to repay and cancel invoices. It was then replaced by a rival supplier by the end of the year.

5.15 Equally, it is important that procurers and contract managers are willing to switch or considering switching. Our case study examining the buying of goods and services by schools found a large degree of inertia when it come to choosing suppliers, with many choosing to remain with existing suppliers whom they knew and felt comfortable with, at the expense of considering alternative suppliers who could offer better value for money.

5.16 However, if commissioners and procurers are willing to switch, but face significant switching costs in replacing suppliers, as set out above, this can also have the effect of entrenching incumbency advantages and reducing the incentives for those incumbent suppliers to improve service provision. Switching costs may arise for a number of reasons in practice:

- the cost of cancelling a specific, relevant contract may be prohibitively high and not recoverable
- the assets or intellectual property (for example in an IT systems contract) may belong to the incumbent supplier, either fully locking the public sector into the contract or making it expensive to switch to a new supplier with a completely new system, and
- the length of time and cost of replacing a supplier may discourage procurers from doing so, particularly if the public service in question is one for which the costs of disrupting supply are large.

5.17 There are numerous examples of a number of Government departments incurring large sunk costs<sup>67</sup> when cancelling contracts. In its recent

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<sup>67</sup> Sunk costs refer to costs that have already been incurred and cannot be recovered even if the project is cancelled.

report on Major Projects,<sup>68</sup> the House of Commons Committee on Public Accounts notes that decisions since October 2010 to cancel defence projects, such as the Nimrod MRA4 anti-submarine aircraft and the Sentinel surveillance aircraft, resulted in the public sector writing off approximately £5 billion while realising little of the expected benefit from the equipment. The prospect of significant cancellation costs may deter commissioners and procurers from considering switching, even in the event of poor performance.

- 5.18 Our case study on facilities management in hospitals reflected the consequences of being unable to switch suppliers, even when it became clear the incumbent supplier no longer offered value for money. In this case, the consequence of these high switching costs could be traced back to a focus on short-term costs when designing the procurement exercise, poor contract management skills and a lack of appropriate data and expertise to effectively evaluate value for money across a longer time-horizon once the contract was awarded.

**Box 5.1: Hospital facilities management**

Many Private Finance Initiative (PFI) contracts combine facilities management with the design and build of hospitals. In a number of cases, the facilities management component of the contract does not appear to provide good value for money. Due to their long contractual periods, hospitals often find themselves unable to switch from their main PFI contractor to other providers of individual services, even if they offer better value for money. We were given an example of being charged £2,000 to move a power socket under a PFI contract compared to £120 under self supply.

Such examples appear, in part, to arise due to a short-term focus on total up-front contract costs rather than individual costs components, meaning the facilities management aspects of the contract are not considered until much later on, at a stage where it became impractical to withdraw or switch an alternative provider.

<sup>68</sup> See [www.publications.parliament.uk/pa/cm201011/cmselect/cmpublic/687/687.pdf](http://www.publications.parliament.uk/pa/cm201011/cmselect/cmpublic/687/687.pdf).

- 5.19 As also discussed in Chapter 4, the use of closed framework contracts, where procurers can only select from a limited number of suppliers, may also limit the ability of procurers and contract managers to move – entirely or not unless expending high switching costs - to more efficient suppliers not on the framework, again leading to barriers to entry for new suppliers.
- 5.20 However, it is important to note that a balance must be struck in ensuring suppliers face incentives to improve their performance through the threat of losing their contract and ensuring commissioners and procurers can attract a diverse supplier base. New suppliers may be deterred from tendering to supply a public service market if they are concerned that the contract, once awarded, could then be arbitrarily terminated by the public sector.
- 5.21 One way to achieve this balance is work with potential suppliers in advance of any tender to ensure there are clear and objective performance targets in advance that can be clearly linked to suppliers' performance. If these performance targets are ambiguous and open to interpretation, procurers and contract managers may face increased risks of legal challenge if they terminate contracts before the agreed date of completion.

**Key insights:**

- **In mature public services markets with large and diverse supplier bases, commissioners and procurers should ensure that contracts with suppliers allow them to switch to more efficient suppliers in the event of poor performance effectively and swiftly.**
- **However, commissioners and procurers need to ensure that while the threat to switch from incumbent suppliers to potentially more efficient suppliers can create appropriate incentives on incumbents, a balance must be struck in ensuring new entrants are not deterred from entering a public service market if they are concerned that the contract, once awarded, could then be arbitrarily terminated by the public sector.**

## 6 CHOICE

### Key insights:

- In public services markets where there are multiple suppliers in the same geographic area, end users can potentially exercise effective choice and this process can help drive better performance by suppliers.
- However, in a number of public services markets where choice is possible, the ability of end users to make well-informed decisions may be limited. They may lack the necessary tools to exercise effective choice or be unwilling to exercise such choice.
- There is an important role for commissioners to ensure that end users have sufficient tools and information to make effective choices if they are to drive suppliers to provide better value for money.

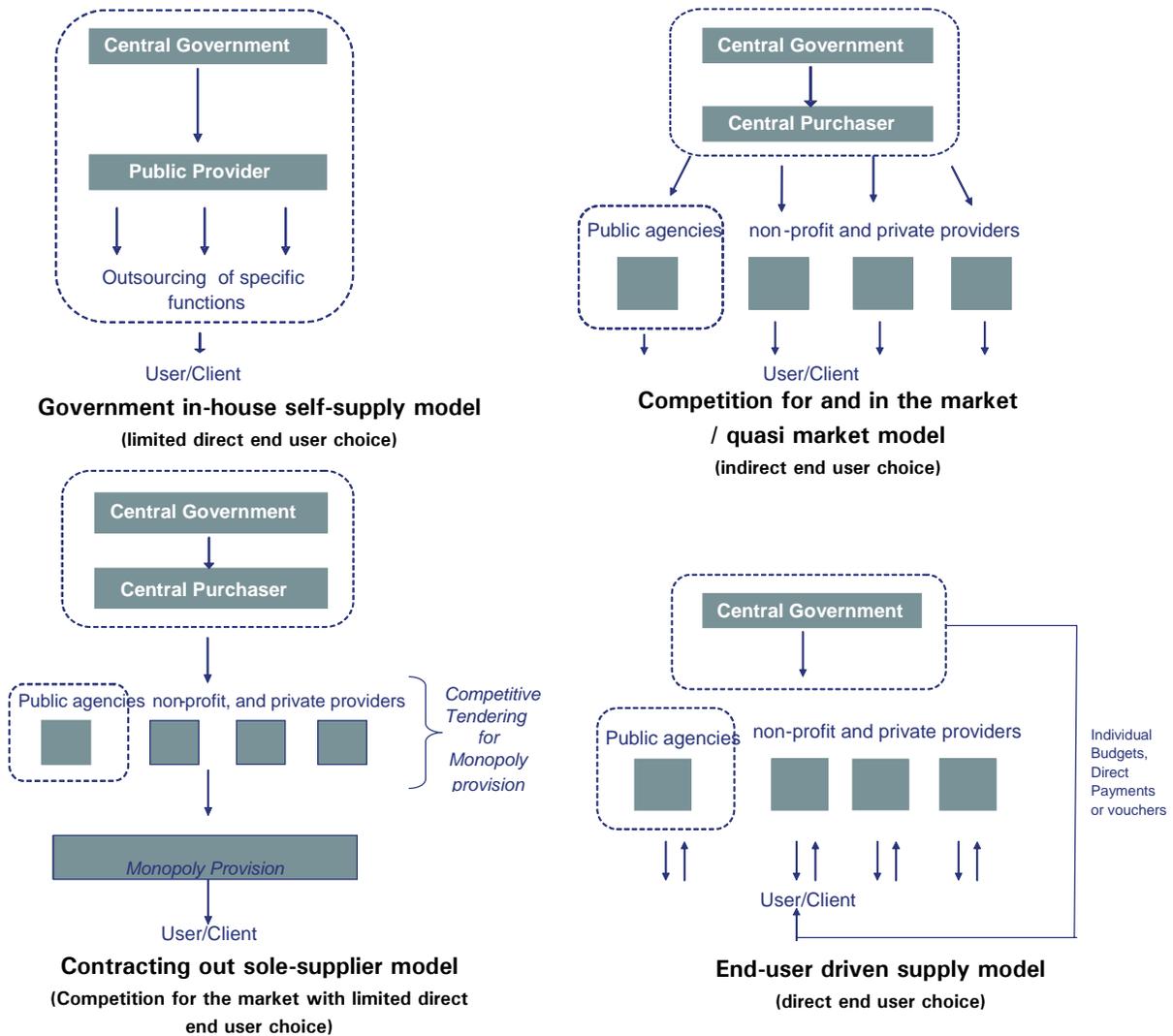
6.1 As discussed in Chapter 3, there are a number of models of public services delivery. When there is a monopoly supplier (either a public sector in-house supplier or a private or third sector contractor), end users may face limited choice in public services markets. In such situations, in the absence of end users driving competition, the incentives for a monopoly provider to improve value for money will need to be part of appropriately tailored, robust contractual and previous performance indicators.

6.2 However, with recent and current Government initiatives increasing the involvement of multiple suppliers in the delivery of public services in the same geographic market,<sup>69</sup> end users can increasingly exercise a choice over which supplier to use. Figure 6.1 below summarises the ability of end users to exercise choice under different public services delivery models.

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<sup>69</sup> The geographic market can be defined as an area in which the conditions of competition applying to the product concerned are the same for all traders. See *OFT/CC Merger Assessment Guidelines* for more details, [www.of.gov.uk/shared\\_of/mergers/642749/OFT1254.pdf](http://www.of.gov.uk/shared_of/mergers/642749/OFT1254.pdf).

**Figure 6.1: End user choice in different procurement models**



Adapted from Struyven and Steurs, (2004)

6.3 As was discussed in Chapter 3, the exercise of effective choice can be a powerful tool in driving positive market outcomes for end users. As LeGrand (2007) argues choice and competition in public services 'fulfils the principle of autonomy, and promotes users' needs and wants; it provides incentives for providers to offer a higher quality service efficiently and in a responsive fashion; and it is likely to be more

equitable than the alternatives'.<sup>70</sup> In situations where there is no (or limited) choice of public service provider, if end users are not receiving high quality public services, the only mechanism they have to initiate quality improvements is through exercising their voice through channels such as making complaints or petitioning commissioners and procurers. This mechanism is, however, more accessible to, and can favour the more articulate and confident end users with pre-existing relationships with commissioners and procurers, at the expense of more vulnerable end users who may not be able to make their voice heard.

- 6.4 The OFT has considered issues of choice and competition extensively<sup>71</sup> across a range of markets in the public and private sectors and explored cases where end users (or consumers) are and are not able to drive competition through the use of effective choice. An example of a previous study, which highlighted the challenges faced by consumers in driving competition, is discussed below.

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<sup>70</sup> Quoted from *The Other Invisible Hand* (2007) by Julian Le Grand.

<sup>71</sup> See for example Choice and Competition in Public Services: a guide for policy makers, [www.offt.gov.uk/shared\\_offt/business\\_leaflets/general/oft1214.pdf](http://www.offt.gov.uk/shared_offt/business_leaflets/general/oft1214.pdf).

### **Box 6.1: Consumer choice in the personal current account market**

In 2008, the OFT's market study in the personal current account (PCA) market found that there were three features of the market that prevented it from reaching an equilibrium that worked in the interests of consumers. These were low levels of transparency on charges and other fees, a perception that switching between PCA providers was risky and low levels of control over the ability to manage finances, especially around unarranged overdrafts.

Taken together, these features meant the virtuous circle between consumers and competition as discussed in Figure 3.1 was not working leading to the market becoming trapped in an equilibrium that did not work well for consumers. PCA providers were not incentivised to offer the services that consumers valued and adopted business models that meant a significant amount of revenue came from less visible charges that were not subject to effective competition. This meant that the market was not delivering value for money for a significant proportion of consumers.

The OFT has subsequently worked with the banking industry to improve the ability of consumers to exercise choice and drive competitive outcomes. A number of initiatives have been agreed with the OFT to increase transparency, improve the switching process and give consumers tools to better manage their finances. See [www.of.gov.uk/OFTwork/markets-work/completed/personal/](http://www.of.gov.uk/OFTwork/markets-work/completed/personal/) for more details.

- 6.5 The following sections build on these observations and apply them to the commissioning and procurement of public services.

### **The ability of end users influencing outcomes when there is a monopoly supplier of public services**

- 6.6 Not all public services will be amenable to end users making individual choices and some public services will require the choice to be made collectively by the community, such as policing.

- 6.7 In the case of a monopoly provider of public services (whether in-house or the private or third sector), end users can influence outcomes in public services markets through a number of indirect routes. These include:
- **through responding and taking part in consultations:** through these, end users can voice their opinions on how public services are being and should be delivered
  - **through making complaints:** end users can voice dissatisfaction with public services through recognised complaints channels to seek improvements, and
  - **through the democratic process:** influencing elected officials through regular voting opportunities, although this can be an imperfect signal of individual preferences on individual issues, as elections will rarely be fought purely on issues concerning public services delivery in one market.
- 6.8 In addition to the above routes, end users also increasingly have other opportunities to provide feedback on providers of public services such as online discussion forums. By sharing experiences of particular suppliers, end users can affect the reputation of suppliers, and this can act as an incentive for suppliers to improve their offering or risk gaining a reputation for poor service which may affect their ability to win future public services contracts.
- 6.9 The Government currently has a number of initiatives which are stated to aim to improve the ability of end users to influence commissioners and procurers in relation to the provision of public services. For example, the Localism Bill contains a provision for a community 'right to challenge', through which communities can challenge local councils over the provision of a service'.<sup>72</sup> Communities that are dissatisfied with a particular service provider could ultimately request that another public

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<sup>72</sup> See <http://services.parliament.uk/bills/2010-11/localism.html>.

services provider be appointed. Such initiatives may have the potential to give end users more effective opportunities to influence and affect the design and implementation of procurement processes in public services markets. However, the OFT notes that these initiatives remain largely untested and at an early stage.

### **The ability of end users influencing outcomes when there are multiple suppliers of public services**

6.10 Recent and current Government initiatives appear to seek to increase the involvement of multiple suppliers in the delivery of public services in the same geographic market and increase the potential for end users to exercise choice and influence outcomes. If end users can choose effectively between suppliers, they can drive competition by switching between suppliers, thereby directly rewarding those suppliers that offer value for money and high quality services.<sup>73</sup>

6.11 However, the ability of end users to drive competition may nevertheless be limited in some public services markets, even with multiple suppliers, due to the following reasons:

- **choice may be limited by geography:** in some public service markets, it may not be practical for end users to switch to alternative suppliers if it entails having to move to a non-local supplier
- **choice may be limited by supplier capacity:** if rival suppliers lack spare capacity and funding arrangements limit their ability to expand or create barriers to exit, then end user choice will simply become a sorting exercise and will not drive competition, as suppliers who

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<sup>73</sup> A potential example of such an initiative in the public sector is that of the Department of Health which states in its White Paper '*Equity and Excellence: Liberating the NHS*', that it intends that patients will have more decision making power, [www.dh.gov.uk/prod\\_consum\\_dh/groups/dh\\_digitalassets/@dh/@en/@ps/documents/digitalasset/dh\\_117794.pdf](http://www.dh.gov.uk/prod_consum_dh/groups/dh_digitalassets/@dh/@en/@ps/documents/digitalasset/dh_117794.pdf).

offer high quality public services will not be able to respond to increased demand by expanding their capacity

- **choice may be limited by a lack of relevant information:** end users may lack relevant and sufficiently accessible information to make effective choices – this may be exacerbated if the quality of the public service can only be determined once it has been bought (a 'credence' service)
- **choice may be limited because end users lack the motivation to choose:** inertia or a lack of knowledge of better alternatives may lead end users simply to accept the public service as provided and not consider switching
- **choice may be limited due to high switching costs:** if end users face high switching costs in moving to a rival supplier, this will impose a barrier to end users exercising choice, and
- **choice may be limited by a lack of clear signalling mechanism:** if end users are unable to clearly signal to suppliers what aspects of public services they most value, then there is a risk suppliers will not focus on these aspects and instead concentrate on other aspects of public services that end users do not value as much.

#### **Box 6.2: Adult residential care home places**

Our case study on residential care homes suggested that end users are not effectively driving competition on price and quality in this market. One of the possible explanations given for this was end-users (in this case, the elderly and/or their children/carers making decisions on their behalf) did not have sufficient information at an early stage in the decision-making process to make well-informed decisions, or that their decisions were influenced by other, more immediate, factors such as a care home's visual aesthetics.

6.12 There are steps that commissioners can take to improve the ability, and motivation, of end users to exercise choice and drive competition. For

example, steps can be taken to give end users relevant and simple information to allow them to make effective decisions.<sup>74</sup>

- 6.13 Effective choice must also be complimented by a lowering of barriers to entry and exit, which will allow the suppliers who offer the best value for money to expand and those that offer poor quality and high prices to be competed out of the market or be forced to improve their offering.

**Key insight:**

- **Where end users purchase public services directly, commissioners should seek to ensure that those end users have sufficient tools and information to exercise effective choice to drive competition.**

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<sup>74</sup> The Department of Health has consulted recently on the provision of relevant information to end users, *Liberating the NHS: an information revolution*, [www.dh.gov.uk/prod\\_consum\\_dh/groups/dh\\_digitalassets/@dh/@en/documents/digitalasset/dh\\_120598.pdf](http://www.dh.gov.uk/prod_consum_dh/groups/dh_digitalassets/@dh/@en/documents/digitalasset/dh_120598.pdf)

## 7 INCENTIVES

### Key points:

- Too often, public sector procurers lack the requisite motivation and skills when involved in public services complex markets to choose the supplier that will offer best value over the long term. Instead, procurers are incentivised to choose suppliers that present the lowest initial price. This will often favour the incumbent supplier over new/smaller suppliers. The reasons for could be due to the relatively short-term political cycle, or perhaps because procurers move on before long-term costs are incurred.
- From the perspective of suppliers, a lack of clarity over the aims and objectives of a particular procurement exercise in public services markets and/or frequent changes in the policy specification can lead to misaligned incentives between suppliers and procurers and commissioners. This can hinder achieving value for money. A lack of clarity or frequent changes to tender specifications may also cause suppliers to either exit markets altogether or raise prices in the face of greater uncertainty/risk.
- In many markets, end users can effectively drive competition through exercising choice and switching service providers. In a number of public services markets, end users are reliant upon commissioners and procurers purchasing on their behalf. It is therefore vital that the incentives of commissioners and procurers are aligned to consider the long-term impact of their decisions, and consider which supplier will deliver the best value for money.
- Equally, commissioners and suppliers should seek to ensure that suppliers' incentives are appropriately aligned to achieve enduring value for money. This can be through embedding into contracts (such as through 'payment by results'), introducing ongoing rating schemes for suppliers and greater transparency.

- 7.1 As discussed in Chapters 3 and 6, there are a number of public services markets in which end users are unable to exercise choice and switch

between suppliers. In such situations, it is important that commissioners and procurers are correctly incentivised to achieve the sustainable value for money end users would otherwise do for themselves. Commissioners and procurers also need to ensure suppliers of public services are incentivised to do so as well.

- 7.2 Our case studies have identified low skill levels amongst staff involved in the procurement of public services. Procurers need to be sufficiently trained to recognise which supplier is offering the best value for money over the long-term. A low awareness of competition and an insufficient understanding of the market, coupled with a high staff turnover among procurement teams and a lack of contract management may lead to an overly short-term focus on achieving cost savings at the expense of value for money.
- 7.3 Commissioners and procurers also need to be able to balance competing strategic objectives and articulate clear priorities to suppliers. While the primary objective of commissioners and procurers may be achieving value for money in public services, they may have to weigh this against the need to facilitate economic regeneration, reduce immediate costs and promote environmental sustainability.
- 7.4 If commissioners and procurers are unable to clearly communicate the strategic, guiding objectives of any given procurement exercise, they risk making it difficult for suppliers to understand what is required of them. Procurers must be incentivised to make decisions on which objectives are of primary importance. If specifications are unclear, or multiple, suppliers will not be able to respond efficiently or innovatively.
- 7.5 Equally, commissioners and procurers need to ensure that suppliers of public services have appropriate incentives to achieve enduring value for money and any other strategic, guiding objectives. This will be particularly important when there is only a sole supplier of public services.

## **The objectives and incentives of commissioners and procurers**

7.6 Examples of multiple strategic objectives of procurement exercises that commissioners and procurers may have in addition to the attainment of value for money include:

- the introduction or promotion of competition in the provision of public services
- job creation and the regeneration of particular areas, and
- promoting environmental sustainability across the supply chain in public services.

7.7 The above strategic objectives are not always mutually exclusive. For example, the promotion of competition will help foster improved productivity and growth, which can increase employment opportunities. However, in other cases, commissioners and procurers will be required to make trade-offs. Examples of some of the potentially more common trade-offs are set out below

**Table 7.1: Examples of trade-offs in commissioning and procurement**

Trade-off	Potential impacts on competition and market development
Local v. national	By procuring nationally, procurers may be able to achieve economies of scale and scope, but such an approach may limit the number of potential suppliers who participate in the process due to the size of contracts. Local procurement may be able to involve a more diverse supplier base, but procurers will be unable to exploit the same levels of buyer power and economies of scale.
Short-run v. long-run	Awarding a contract to deliver public services to a larger supplier in the public, private or third sectors may represent cost savings in the short-term, but this may lead to rival suppliers exiting the market and, in the long-term, reducing market capacity and entrenching incumbency advantages.
Large v. small firms	Awarding a contract to deliver public services to a larger supplier in the public, private or third sector may yield lower prices and more scope for innovation and appropriate allocation of risk, by contrast, by choosing a smaller firm there may be a greater impact in expanding and diversifying the supplier base, which could lead to more innovative capacity across the market in the long-term.

7.8 Ideally, commissioners and procurers when determining the appropriate balance between competing strategic objectives would consider:

- the nature and size of the market and supplier base
- the desire to develop local or regional markets
- the nature of the public service, for example, is it personalised public service that requires specific local knowledge or not

- the value of the contract
- the importance of local brands and a local network of suppliers to users
- whether the existence of economies of scale suggest centralised buying would lead to better value
- the ability of the relevant consumers to make effective choices.

### **Clarity of objectives**

- 7.9 Following the complex process of balancing competing strategic objectives, commissioners and procurers will need to articulate the guiding strategic objectives to suppliers of public services (in the public, private and third sectors). Suppliers of public services need to be aware of, and understand, the main purposes of the procurement exercise so they are able to make decisions with certainty and can better achieve the objectives set by the commissioner.
- 7.10 This is particularly important where commissioners and procurers are involving private and third sector suppliers for the first time in a public services market – the overarching strategic objectives for a procurement exercise should be clearly articulated to ensure new suppliers have a clear idea of their role and the type of market being created.
- 7.11 If objectives are not clearly articulated and communicated or are frequently changed by commissioners and procurers to suppliers, this can lead to suppliers either raising prices to factor in greater uncertainty/risk or withdrawing from the market altogether. Over time this will lead to a shrinking supplier base and reduced incentives on existing market participants to invest and innovate.

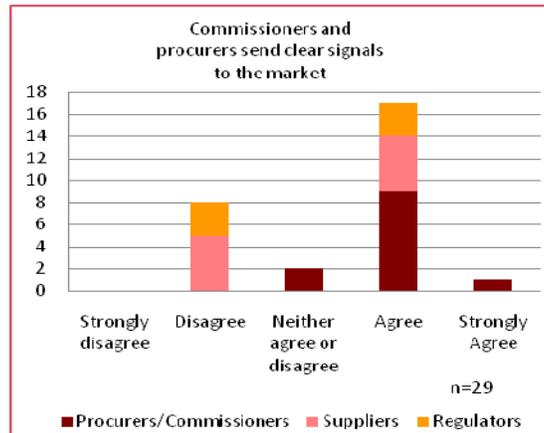
### **Box 7.1: Prisons and the Flexible New Deal**

Our case study on prisons reflects the adverse impact of commissioners and procurers failing to signal strategic objectives sufficiently. While one of the objectives of National Offender Management Service (NOMS) is to create a dynamic market with diverse providers, some past actions - such as the cancellation of a lengthy and costly bidding competition and the private sector not always being invited to bid for contracts - meant a rise in bidding costs and unclear signals received as to the overarching strategic objectives of commissioners, effectively creating barriers to entry and making it difficult for suppliers to make long-term plans.

Similarly, our case study on the Flexible New Deal for welfare-to-work showed that while one of DWP's overarching objectives in its Commissioning Strategy was to create competition 'for' and 'in' the market by contracting to a number of prime providers, many primes in fact reported a significant lack of clarity as to the type of market DWP was striving to create, 'with some respondents reporting a tension between a desire to be both laissez-faire and to steward the market'. This lack of clarity over how much should be left to market forces and individual suppliers and how much would be directed by DWP, contributed to uncertainty among potential suppliers as to what the desired characteristics were of a potential prime, limiting the number of bids.

- 7.12 PwC's research also indicated that suppliers are often unclear over the overarching strategic objectives of procurement exercises.

**Figure 7.1: Signals sent to the market from six case studies**

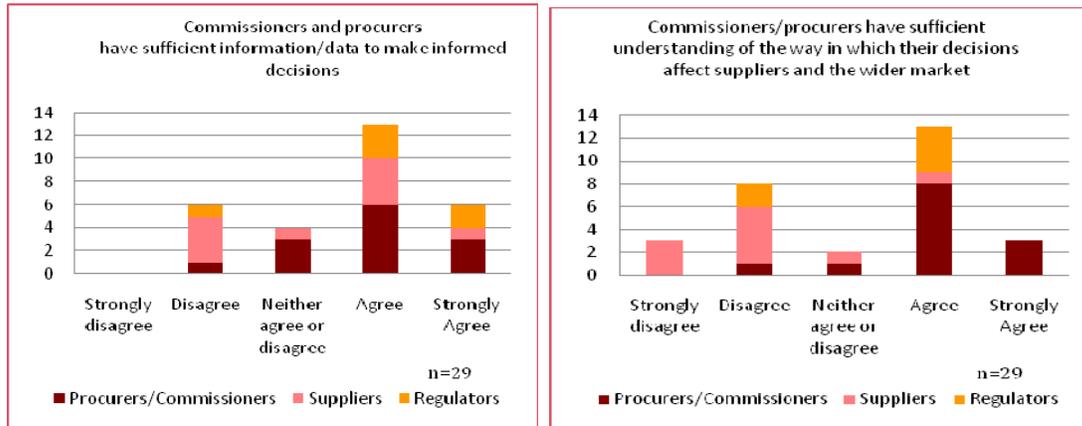


Source: PwC

### **Procurer and commissioner skills and incentives**

- 7.13 To achieve value for money it is important that the incentives of commissioners and procurers are aligned. There are number of reasons for commissioners' and procurers' incentives not being focused on achieving value for money, and instead focusing on other goals, such as short-run cost minimisation.
- 7.14 By way of setting the context for a discussion on incentives, PwC sought suppliers' views on commissioners' and procurers' skills and understanding of procurement processes and their impact on the market. PwC's research showed many suppliers claimed public sector commissioners and procurers did not have the skills or understanding of the products they were purchasing in order to make informed judgements on what each prospective supplier could offer and how. It was claimed this may be a relevant factor in assessing why procurers tend to focus on short-term tender price, which is easier to understand.

**Figure 7.2: Supplier views of commissioner and procurer skills from six case studies**



Source: PwC

- 7.15 Organisational structures within the public service mean that commissioners and procurers are often rewarded for delivering the project or policies on time and within budget. However upon the successful delivery of a major project very few commissioners and procurers will remain in their post. Some will be promoted or moved on to deliver other projects. Junior members of staff are encouraged to move post frequently to gain a wider range of experience. The biggest risk to commissioning and procurement staff is short term failure to deliver which may have a significant impact on career progression. Taken together, this may produce incentives to focus on the very short term and to avoid more adopting innovative, higher risk processes and/or commissioning and procurement solutions whenever possible.
- 7.16 Our adult residential care homes case study reflects the adverse consequences of commissioners and procurers focusing on achieving short-run cost savings in the provision of adult care services at the expense of long-run value for money and market development.

### **Box 7.2: Adult residential care homes**

Local authorities have been focusing more and more on commissioning the provision of adult care services from the private and third sectors, as opposed to providing the services themselves. However, there appears to be agreement between commissioners, suppliers and wider industry experts that commissioning skills were widely lacking. The result of low skill levels was that the focus of local authorities was on short-term price and that contracts for adult care services are poorly designed by commissioners and procurers – one local authority admitted to paying 80 per cent of bed costs, even when that person they were paying for had gone to hospital.

- 7.17 The case study also highlighted the adverse impact rapidly changing strategic objectives can have on public services markets. In this case, as the consequences of driving down short-term costs manifested themselves through lower quality adult social care, commissioners and procurers moved to focus on choosing suppliers on the basis of quality rather than price. However, over time, this higher quality was associated with rising prices, leading commissioners and procurers to refocus on achieving cost savings. This created a lack of consistency and clear strategic direction on the part of local authorities and potentially sent out unclear signals to private and third sector suppliers as to what the objective of procurement exercise was. It also potentially raised a barrier to entry for potential entrants who, faced with uncertainty over the objectives of procurement, found it harder to plan and invest appropriately.
- 7.18 One possible route to ensure incentives for commissioners and procurers are more appropriately focused is to increase their accountability to end users.
- 7.19 One mechanism for increasing accountability is increasing transparency. Greater transparency in commissioning and procurement processes has the potential to reduce entry barriers and to help procurers to achieve

value for money through benchmarking and comparing rival supplier offers. New websites such as Contract Finder<sup>75</sup> have the potential to raise greater awareness of tender opportunities for suppliers and allow procurers to carry out benchmark analyses to compare bids.

7.20 However, greater transparency does carry with it certain risks. First, greater information on bid prices can potentially assist in collusive behaviour by suppliers. Greater transparency on prices increase suppliers' ability to monitor other suppliers' bids and put in place retaliatory mechanisms. It allows prospective suppliers to see what successful suppliers have bid in previous procurement exercises and use this as a basis for subsequent bids. This will reduce price competition and make it harder to achieve efficiency savings.

7.21 Second, if it is only the price of successful bids which is made transparent to suppliers and end users, then it is likely to become the focus for competition at the expense, potentially, of innovation and quality improvements. Solely publishing price information, without placing it alongside information on supplier quality, may lead to commissioners and procurers becoming incentivised to only focus on achieving short-term price savings at the expense of long-term value for money because this will be the only dimension of value for money commissioners and procurers are held accountable on.

**Key insights:**

- **The strategic, guiding objectives behind commissioning and procurement exercises need to be clearly communicated and understood, so that the commissioners, procurers and suppliers are aware of them, and their incentives can be appropriately aligned to achieve these objectives.**
- **Unclear and constantly changing strategic, guiding objectives have the potential to obscure suppliers' incentives to increase efficiency, improve quality and innovate.**

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<sup>75</sup> See [www.contractsfinder.businesslink.gov.uk/](http://www.contractsfinder.businesslink.gov.uk/).

- **While greater transparency of commissioning and procurement processes can improve the accountability of commissioners and procurers to end users, it is important that publicly available information on supplier contract awards captures all elements used to assess value for money (including quality), so as not to distort commissioners' and procurers' incentives to solely focus on price.**

## **The incentives of suppliers**

- 7.22 Where potential suppliers compete for the right to be the sole supplier ('competition for the market') it becomes very important to ensure that there is rigorous competition before the contract is awarded. In the long term, consideration needs to be given to mitigate against creating incumbent public service providers who in future tender rounds to supply the market will not face credible competition.
- 7.23 There is also the risk that, faced with heavy competition, suppliers who win the right to supply bid so low that they fail to deliver after the contract is let (a form of 'winner's curse'). The winner's curse refers to the idea that in a competitive auction the winner will be the one who bids the highest, but overestimates the value of the item. This means they end up paying too much for the item. In the case of public services competitive tendering, the winner's curse can apply if the winner of a tender process finds itself unable to recover costs and meet procurement objectives due to bidding too low. In such cases, the supplier may find itself unable to accommodate any rise in the costs of supply or deliver public services in the face of changes in market conditions. If this leads to supplier failure, commissioners will be faced with the problem of ensuring services continue to be delivered if a supplier becomes insolvent, as discussed in Chapter 5.
- 7.24 The Government is considering, or already implementing,<sup>76</sup> a number of new mechanisms to create stronger incentives for suppliers to improve

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<sup>76</sup> See Annexe B for further details.

value for money and long-term performance, both when there is 'competition for the market' or 'competition in the market'. Some examples are listed below.

- **Introducing 'payment by results'**, with the aim of creating contractual incentives for suppliers to focus on improving outcomes, rather than simply focusing on the cost of inputs. Incentives are created through the payment being agreed and fixed at the start of the contract, meaning that if the supplier is able to deliver the output or outcome more cheaply during the life of the contract, by making efficiency savings or using a more innovative delivery model, they will be able to achieve greater returns over the life of the contract.
- Improving and in some cases **implementing processes for benchmarking** costs and performance of suppliers. Incentives can be created for suppliers to improve performance if they know they will be compared to rival deliverers of public services and risk losing market share and contracts to them if their performance is below their rivals' standards.
- **Introducing competition 'in the market' as well as 'for the market'** to facilitate the benchmarking process and to let end users themselves exercise effective choice by rewarding those suppliers that offer a good deal with greater market share.
- **Introducing ongoing rating schemes for suppliers** which can be taken into account by commissioners and procurers when renewing existing public services delivery contracts.<sup>77</sup> Suppliers will be incentivised to improve their performance or risk receiving a poor rating and not having their existing contract renewed.

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<sup>77</sup> Such an arrangement was used in Australia with the introduction of a 'star ratings' system to allow comparisons of different welfare to work providers.

- **Improving transparency and accountability by providing details of all public contracts**, including details on cost and quality, to end users. This can incentivise suppliers to achieve value for money, if they know commissioners and procurers are accountability to end users for ensuring suppliers demonstrate value for money.
- **Implementing effective failure regimes and mechanisms for switching**. As discussed in Chapter 4, commissioners and procurers can incentivise suppliers to achieve value for money in public services markets through the threat of switching to alternative suppliers.

7.25 These mechanisms can create strong incentives for suppliers to improve their offering, but if implemented without fully considering the wider market and supplier base, they can raise barriers to entry and exit.

7.26 A particular issue relates to greater transparency around previous supplier contracts in public services markets. While more public information on previous contracts can improve commissioner and procurer incentives to focus on value for money due to greater accountability, if this information only relates to price, and not other dimensions of value for money such as quality, it can raise the potential for price collusion amongst suppliers. By only providing price information on the successful supplier in previous contract tenders, suppliers preparing bids to current contract tenders will be able to compare their bids to this and potentially collude in raising prices above this. This will reduce price competition and make it harder to achieve efficiency savings.

## **A PARTIES CONSULTED OR WHO SUBMITTED EVIDENCE TO THE OFT**

A.1 As part of this study, PwC contacted and held detailed discussions with a wide range of commissioners and procurers in the public and private sectors, suppliers of public services and supply associations. These discussions were confidential.

A.2 Below is a list of parties additionally consulted by the OFT or who submitted evidence to the OFT in the course of this study. The OFT would like to express its thanks to all of those individual commissioners, procurers, suppliers and related organisations involved for their contributions to this study.

Association of Chief Executives of Voluntary Organisations

Association of Signals, Lighting and other highway Electrical Contractors

BDO LLP

British Services Association

Charity Commission

Citizens Advice

Confederation of British Industry

Co-operation and Competition Panel

The Consortium for Purchasing & Distribution Ltd

Federation of Small Businesses

Foundation Trust Network

Institute of Commissioning Professionals

The Institute of Government

The Kings Fund

Marc1 Limited

OpenForum Europe

Society of Local Authority Chief Executives and Senior Managers

Society of Purchasing Officers

Spend Matters UK

UK E-Invoicing Advocacy Group

Wragge & Co

Suffolk County Council

Zurich Mutual

## B CURRENT AND FORTHCOMING INITIATIVES

B.1 The Government has announced a series of measures designed to improve efficiency and reform procurement practices and processes. The list below captures a selection of some of the relevant initiatives that are being implemented, or have been announced, by central, local and devolved Government.

- A review by Sir Philip Green, published in October 2010, examining government spending and making a number of recommendations on how the Government can 'leverage both its credit rating and its scale' to secure cost savings.<sup>78</sup> A series of 'deep dive' reviews of selected spend categories, such as in energy, professional services and office solutions by ERG<sup>79</sup> with the aim to base-line the current position and set out immediate actions to improve the supply and reduce costs.
- A package of measures<sup>80</sup> announced in February 2011 designed to make it easier for SMEs and third-sector organisations to compete for public sector contracts including:
  - the launch of a Contracts Finder website which contains information on available public sector contracts above £10,000 and information on all central government tender documents and contracts above £10,000

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<sup>78</sup> See *Efficiency Review by Philip Green – Key findings and recommendations* <http://download.cabinetoffice.gov.uk/efficiency/sirphilipgreenreview.pdf>.

<sup>79</sup> From John Collington's presentation at the 'Delivering More for Less' conference on 24 November 2010 - <http://network.civilservicelive.com/pg/file/Confadmin/read/521395/john-collington>.

<sup>80</sup> For a full list of these measures see [www.cabinetoffice.gov.uk/news/government-opens-contracts-small-business](http://www.cabinetoffice.gov.uk/news/government-opens-contracts-small-business).

- the appointment of a new Crown Commercial Representative (CCR) by Cabinet Office for SMEs whose task will be to build a more strategic dialogue between Government and smaller suppliers.
  - the launch of SME 'product surgeries' led by the CCR for SMEs which aims to give them the opportunity to pitch innovative products and services direct to a panel of senior procurement and operational professionals from central government and the wider public sector, and
  - and moves by Cabinet Office to eliminate the use of PQQs for central government contracts under £100,000 and allow suppliers to submit pre-qualification data once for all procurements in common commodities.
- The publication in February 2011 of a Lean Review<sup>81</sup> on procurement processes which identified significant potential to reduce turnaround times in the time taken to commission and procure public services, costs to participating suppliers and related government resource and processing costs.
  - The Welsh Assembly along with other partners such as trade unions and voluntary organisations, is working through the Efficiency and Innovation Programme to promote better use of technology, increased use of collaborative procurement and to encourage innovation in the delivery of public services.<sup>82</sup>

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<sup>81</sup> See Accelerating Government Procurement: Management Summary of the findings of a 'lean' study to investigate waste and inefficiencies in government's procurement process, [www.cabinetoffice.gov.uk/sites/default/files/resources/lean-study-accelerating-government-procurement.pdf](http://www.cabinetoffice.gov.uk/sites/default/files/resources/lean-study-accelerating-government-procurement.pdf).

<sup>82</sup> See <http://wales.gov.uk/docs/dpsp/publications/101711eisleafleten.pdf>

- In Scotland, the government has recently concluded a consultation on the standardisation of PQQs.<sup>83</sup> It is currently undertaking a number of initiatives around procurement, including seeking views and information from the market regarding potential requirements for an electronic invoicing solution and sponsoring training on the EU Public Procurement Directive for procurement professionals in the Scottish public sector.<sup>84</sup>

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<sup>83</sup> See [www.scotland.gov.uk/Topics/Government/Procurement/Procurement-News/sPQQconsultation](http://www.scotland.gov.uk/Topics/Government/Procurement/Procurement-News/sPQQconsultation).

<sup>84</sup> See [www.scotland.gov.uk/Topics/Government/Procurement](http://www.scotland.gov.uk/Topics/Government/Procurement) for further details.

## **C PAST OFT REPORTS IN PUBLIC MARKETS AND PROCUREMENT**

- C.1 This study builds on the OFT's track record of delivering market-based solutions and its previous experience of examining procurement and public markets issues. This study forms part of the OFT's wider commitment in relation to its public markets priority area, as set out in Annual Plan 2010-11.<sup>85</sup>
- C.2 A selection of the most relevant previous reports and guides by the OFT is listed below.
- In 2004, a report by Dotecon, commissioned by the OFT, on the impact of public procurement on competition in markets, and likely sectors in which the public sector is likely to be in a position to affect competition.<sup>86</sup>
  - In 2010, a report on competition in mixed markets and competitive neutrality, examining issues around ensuring there is a 'level playing field' between public, private and third sector providers of goods and services.<sup>87</sup>
  - In 2010, a report by Frontier Economics, commissioned by the OFT, on choice and competition in public service markets, and some key challenges facing policy makers.<sup>88</sup>
  - In 2009, a summary guide on the role of Government in markets, explaining how its interventions can affect markets in both positive

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<sup>85</sup> See OFT Annual Plan 2010-11, [www.of.gov.uk/shared\\_of/about\\_of/706647/of1215.pdf](http://www.of.gov.uk/shared_of/about_of/706647/of1215.pdf).

<sup>86</sup> See [www.of.gov.uk/OFTwork/markets-work/completed/procurement](http://www.of.gov.uk/OFTwork/markets-work/completed/procurement)

<sup>87</sup> See [www.of.gov.uk/shared\\_of/economic\\_research/of1242.pdf](http://www.of.gov.uk/shared_of/economic_research/of1242.pdf)

<sup>88</sup> See [www.of.gov.uk/shared\\_of/business\\_leaflets/general/of1214.pdf](http://www.of.gov.uk/shared_of/business_leaflets/general/of1214.pdf)

and negative ways, and offering practical advice on how to minimise negative effects on competition.<sup>89</sup>

- In 2004, a study considering the effects on competition of Government subsidies given to private business, including recommendations on identifying the costs and benefits of subsidies.<sup>90</sup>
- In 2006, a market study on the commercial use of public information (CUPI) demonstrating how greater competition in public sector information could benefit the UK economy by around £400 million annually.<sup>91</sup>
- In 2006, a joint-study with the Office of Government Commerce (OGC) on the effects of public procurement on competition in the municipal waste management sector.<sup>92</sup>

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<sup>89</sup> See [www.offt.gov.uk/shared\\_offt/business\\_leaflets/general/OFT1113.pdf](http://www.offt.gov.uk/shared_offt/business_leaflets/general/OFT1113.pdf)

<sup>90</sup> See [www.offt.gov.uk/shared\\_offt/reports/comp\\_policy/oft750.pdf](http://www.offt.gov.uk/shared_offt/reports/comp_policy/oft750.pdf)

<sup>91</sup> See [www.offt.gov.uk/shared\\_offt/reports/consumer\\_protection/oft861.pdf](http://www.offt.gov.uk/shared_offt/reports/consumer_protection/oft861.pdf)

<sup>92</sup> See [www.offt.gov.uk/news-and-updates/press/2006/87-06](http://www.offt.gov.uk/news-and-updates/press/2006/87-06)