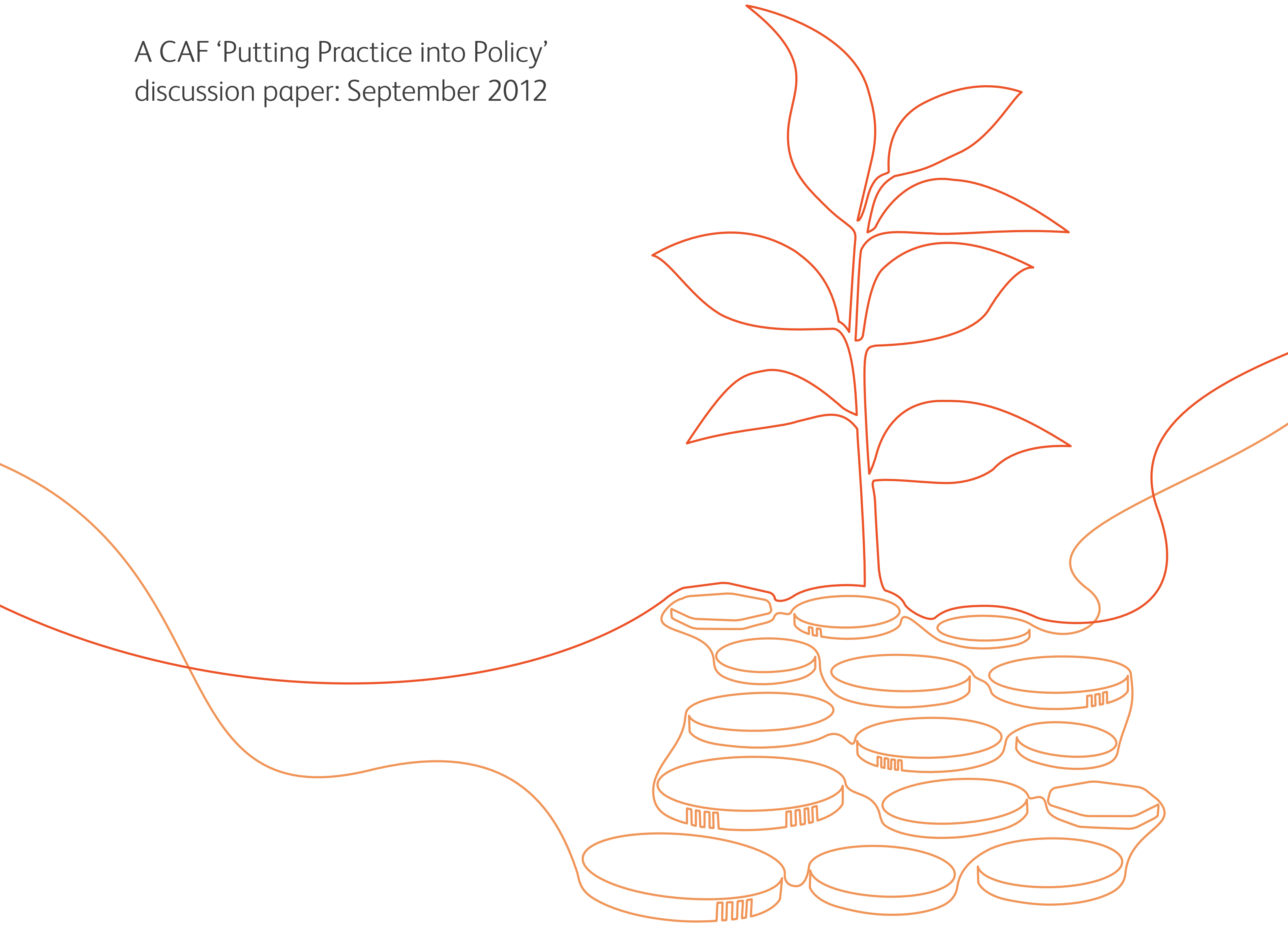
FUNDING GOOD OUTCOMES

Using social investment to support payment by results

A CAF 'Putting Practice into Policy' discussion paper: September 2012



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Summary

This is the first of a series of evidence-based discussion papers from the Charities Aid Foundation (CAF), drawing on our experience of working to ensure the effective funding of civil society in order to highlight key issues and make recommendations for future policy development. This discussion paper primarily draws on a decade of financing experience through our pioneering social investment arm, CAF Venturesome.

In recent years, an increasing number of the investments CAF Venturesome has made have been linked to charities' involvement in public service delivery. This has included dealing with many requests for finance from organisations with payment by results contracts. The lessons learned from that experience have informed this report, which has been written by Rhodri Davies, Policy Manager at CAF.

Payment by results and outcomes

Until now, when a non-State provider such as a charity or social enterprise was commissioned to deliver a public service it would usually be on the basis of a contract to undertake a specified activity, and payments would be made as long as the terms of the contract were met. However, the Government is increasingly looking to move away from this model and instead use a payment by results (PbR) approach. As the name suggests, PbR means that a deliverer does not get paid automatically, but only if certain agreed results are delivered[1].

Allied to the increased use of PbR is a move towards focussing the commissioning process on outcomes (ie the actual social outcomes produced) rather than on other measures such as outputs or inputs as would have been the case in the past. These two trends are linked, because the results in many PbR schemes are framed in terms of outcomes.

PbR based on outcomes presents a real opportunity for not-for-profit organisations to win public service delivery contracts. As the focus is shifted away from the exact nature of the service provided towards the outcomes produced, there is more room for innovation and greater freedom for not-for-profits to demonstrate the effectiveness of their approach. This is perhaps the most positive aspect of the PbR trend.

1 We should perhaps be careful about overstating the impact of the trend toward PbR. A recent New Philanthropy Capital (NPC) report examining charities' experience of public sector commissioning (http://www.philanthropycapital.org/publications/improving_the_sector/commissioning.aspx) found that the most common forms of funding were still block contracts and grants. Whilst there are changes, 'they are not seismic'.

The growth of payment by results

The following are examples of government programmes that use a PbR approach:

- The Work Programme[2]: The largest PbR fund launched so far, run by the Department of Work & Pensions (DWP). Prime contracts have been awarded to 18 organisations, which then offer smaller PbR subcontracts to organisations at a local level. Not-for-profits are mostly involved as subcontractors. There have been widely reported issues with the programme, including many stories of not-for-profits pulling out[3].

- Working with Troubled Families Fund[4]: A £200m fund led by DWP using money allocated to the UK from the European Social Fund, and administered by eight welfare to work providers in conjunction with local authorities. The fund aims to help people in families with multiple problems to overcome barriers to finding employment. The majority of work on the ground will be delivered by not-for-profits on a PbR basis.

- The Innovation Fund[5]: A new fund of up to £30m, run by DWP for three years from 2012. The fund aims to support projects which support disadvantaged young people and those at risk of disadvantage. Payments are made for the delivery of agreed outcomes.

- Troubled Families Financial Framework[6]: A programme run by the Department for Communities and Local Government which offers additional results-based payments to local authorities for dealing with troubled families.

- The Peterborough Pilot[7]: Perhaps the Government's flagship PbR innovation. This a scheme to reduce short-term reoffending amongst inmates released from HM Prison Peterborough. It is structured as a Social Impact Bond, bringing in external social investment.

- The Youth Contract[8]: In July, the Office of the Deputy Prime Minister launched a £126m PbR fund as part of the Youth Contract, aimed at helping young people between 16 and 19 who are not in education, employment or training (NEETs) to get back on their feet. The programme is run on a prime/subcontractor model similar to the Work Programme.

- Acute health care services[9]: The Department of Health currently uses PbR to fund the majority of acute services in hospitals. Commissioners pay healthcare providers for each patient seen or treated, taking into account the complexity of the patient's healthcare needs.

2 http://www.dwp.gov.uk/docs/the-work-programme.pdf
3 http://www.thirdsector.co.uk/Policy_and_Politics/article/1136329/fifteen-sector-organisations-left-work-programme-second-half-last-year/
4 http://www.dwp.gov.uk/newsroom/press-releases/2012/jan-2012/dwp001-12.shtml
5 http://www.dwp.gov.uk/supplying-dwp/what-we-buy/welfare-to-work-services/innovation-fund/
6 http://www.communities.gov.uk/publications/communities/troubledfamiliesframework
7 http://www.socialfinance.org.uk/sites/default/files/SF_Peterborough_SIB.pdf
8 http://www.dpm.cabinetoffice.gov.uk/news/radical-scheme-rescue-neets-kicks-today
9 http://www.dh.gov.uk/prod_consum_dh/groups/dh_digitalassets/documents/digitalasset/dh_128864.pdf

However PbR also presents a challenge for charities and social enterprises, in terms of raising working capital[10]. PbR contracts are by their nature end-loaded: you get paid some or all of the money only at the end, when you have produced the agreed results. The problem is that an organisation needs money to pay for the work it has to do in order to deliver those results. For most private sector service providers this is not a problem, as they will be able to call on their own resources or obtain commercial loans to cover their working capital needs. For not-for-profits, however, which are often asset-poor, have limited reserves and may be unable to access commercial finance, the working capital gap can present a real obstacle.

Case study

Eco Actif: the working capital gap in PbR contracts

The challenges that PbR can present for not-for-profits are vividly demonstrated by the case of Eco Actif, a community interest company (CIC) that recently went into liquidation because it was unable to cover its working capital requirements[11]. As reported in the press, Eco Actif was involved in the Government's PbR Work Programme, as part of a supply chain managed by A4e. Eco Actif maintains that the issue was lack of access to capital. The firm had a good track record, and a £1m order book, but it was reported that both commercial banks and social investors were unwilling to lend Eco Actif the money they required on the grounds that dependence on the Work Programme is too high risk. Obviously there are other issues at play here, to do with the prime-contractor/sub-contractor model in general and possibly to do with the particular role of A4e (which has generated a large amount of negative publicity around its involvement in the Work Programme)[12], but it is clear that part of the problem is the challenge that end-loaded PbR contracts present for asset poor not-for-profits.

Social investment has the potential to solve this problem by offering investors (with a higher tolerance for financial risk) the chance to support organisations providing working capital to not-for-profits with PbR service delivery contracts. The central idea is that if agreed social outcomes are delivered, investors will be able to get a financial return based on the payments made by the commissioner for those outcomes.

10 There is definite concern amongst charities that the problems caused by PbR will outweigh the benefits. The NPC report mentioned above found that 55% of charities surveyed thought that PbR contracts would have a negative impact on their financial security.

11 http://www.guardian.co.uk/politics/2012/jul/15/welfare-work-firm-bankrupt

12 http://www.guardian.co.uk/uk/2012/jun/28/a4e-failing-work-programme-targets

Social investment approaches to financing PbR

There are potentially many ways in which social investment can be used to address the working capital issue. Most of these involve a commissioner, a not-for-profit delivering the service and an intermediary that structures the investment. The key feature of all of the approaches is finding a way to reduce the risk involved to a level that is acceptable to the commissioner. A few possible examples are outlined below. This list is not intended to be definitive. The market is extremely new and developing all the time, so some of these approaches may not have been put into practice and there may be other models that we have not even thought of yet.

Example 1: Public Service delivery agreement is with not-for-profit

A more direct approach is for an investor or intermediary to offer a loan to a not-for-profit that has won a PbR contract in order to cover its working capital needs. In this situation, there is not necessarily any direct relationship between the commissioner and the social investor – in fact the commissioner may not even be aware that the not-for-profit is seeking external investment. Repayment of the loan might itself be outcomes-based, ie, it is only repaid (at an agreed rate of interest) when the results are delivered and contractual payments are received. Alternatively, the lender might establish a timetable for repayment that requires the delivery agent to start paying earlier than that. This then raises a question about the balance of risk and what happens in the event that outcome goals are not met.

Example 2: Public Service delivery agreement is with social investment intermediary

Social impact bonds (SIB) are an example of an approach where the key relationship is between the commissioner and an intermediary (although the actual contract is with a separate special purpose vehicle). An SIB is a financial structure underpinned by an agreement with a public sector commissioning body. It enables investors to put money in on the basis that they will receive a financial return based on the saving to the State if certain agreed social outcomes are delivered. Currently there is only one SIB with any sort of track record (focused on reducing short term reoffending amongst prisoners released from HM Prison Peterborough)[13], but more have been announced both in the UK and abroad, including one in Merseyside focused on helping disadvantaged young people, which CAF Venturesome has invested in[14].

Example 3: Underwriting/Guarantees

Another use of social investment would be to offer financial guarantees or underwriting facilities. This might involve a social investor underwriting/guaranteeing a loan made by a commissioner or vice versa. The Goldman Sachs (see page 7) case study is an example of the former kind. In these situations there is a clear benefit for the organisation making the loan, as the risks are significantly reduced. The question is: what is the benefit for the organisation providing the guarantee/underwriting? The obvious way to deliver a return is to charge fees or interest for the underwriting/loan facility, although this may have implications for the interest rate paid by the not-for-profit.

13 http://www.socialfinance.org.uk/sites/default/files/SF_Peterborough_SIB.pdf
14 http://www.triodos.co.uk/en/about-triodos/news-and-media/media-releases/triodos_new_horizons/

Key issues

i) Risk

Risk is the key issue in terms of the use of social investment to fund public service delivery. We have already seen that it is possible to reduce the level of risk faced by commissioners by combining PbR approaches with social investment approaches. But there is an issue if the risk is effectively 'outsourced' entirely (either to investors or to not-for-profits), as is true of the majority of PbR-based contracts that we have seen in the market so far. Whilst it may be necessary for pragmatic reasons to mitigate the risk faced by commissioners, it is surely not appropriate to enable them to get the reward of savings without bearing any of the risk of failure at all?

The balance of risk

It is not right for the burden of risk to be entirely outsourced to not-for-profits. CAF believes that PbR contracts should combine up-front payments, to cover some portion of core costs, and at-risk success payments, paid in arrears. This would present a fairer deal for not-for-profits and a more appropriate financial risk for commissioners[15]. It is also not appropriate to exploit the social motives of investors by asking them to take on the entire burden of risk. This problem is exacerbated if the commissioner (or intermediary) is also attempting to leverage in commercial finance. In order to make the investment attractive, it will almost certainly be necessary to structure it so that commercial investors are 'shielded' by social investors, whose motivation allows them to have a greater tolerance for the risk that they will not receive a financial return.

CAF does not believe that this is right. Expanding the investor base to include investors who may prioritise near-commercial returns over the needs of social investors and not-for-profits is not appropriate whilst PbR remains unproven as a mechanism of delivering social outcomes[16].

Risks caused by commissioning practice

Some of the risks in PbR stem from deficiencies in the way the commissioning process operates. Despite the fact that there is usually sufficient time within the process as a whole, social investors are often not brought in until just before the final deadline, so they only have a very small window in which to do the required due diligence on the investment. This increases the level of investor risk unnecessarily, as the problem could easily be overcome by extending the length of the commissioning cycle or simply involving potential investors at an earlier stage.

15 The Audit Commission, in its briefing on 'Local Payment by Results' (http://www.audit-commission.gov.uk/SiteCollectionDocuments/Downloads/20120405localPbR.pdf), is clear on this issue. "If a scheme links all payment to results, the risks for the provider may be very high...Small providers, including voluntary organisations or small businesses, may not be able to carry the financial risk of failure if the amount of money at risk is very large and so may not bid to provide services."

16 The same Audit Commission briefing notes that "Schemes that make a large part of the payment dependent on performance are, for the most part, untested and their overall effectiveness is not yet proven."

However there is a further problem: even when social investors are involved, they may not be able to perform the desired amount of due diligence because of the way the commissioner is managing the process. In some cases, commissioners are making it a requirement that not-for-profits who wish to bid and compete for PbR contracts are able to show evidence that they can secure external investment. But because this happens well before the contract is actually agreed, social investors and intermediaries are being asked to make a judgement without sufficient information. In this case they are either being forced to take undue risks, or their indication of willingness to invest will have to be laced with so many caveats as to be almost worthless.

There are also long-standing issues about the way the commissioning process deals with not-for-profits which can have knock-on effects for investors[17]. One of these is the recurring problem that not-for-profits often do not have extensive experience of contract negotiation, and the costs of buying in legal expertise are prohibitive, so they can find themselves at a disadvantage and end up saddled with unfavourable terms in their delivery contracts. This may be a particular problem when it comes to PbR contracts and the use of outcomes, because these are such new areas and even an organisation's previous experience of public service contracting might not be that much help. If not-for-profits lack the necessary influence with commissioners or private sector prime contractors to achieve an appropriate level of risk sharing in PbR contracts, it may result in PbR contract holders having no control over the 'inputs' (eg number of people referred to it under the PbR contract) and therefore no downside risk protection. This would markedly increase the risk of investing in any product that provided working capital to such a not-for-profit, and therefore make it less appealing to investors or drive up costs.

ii) Returns

Since there are risks involved in PbR and the social investment models built upon it, there must also be returns that make those risks worth taking; either financial or social (the latter will be dealt with in the next section). In the same way that there are issues about the way that risk is apportioned between commissioners, not-for-profits and investors, there are issues about how each group benefits financially from success.

The most obvious group to benefit financially are the investors. This does raise the question of whether it is acceptable for private investors to pay for addressing social needs and to receive a financial reward for doing so, although there is clearly a difference between social investors who put profits back towards social good and commercial investors who retain profits for themselves. In either case, of course, it is still in the end the commissioner that pays for successful interventions, through the underlying PbR contract, but it is true that allowing investors to 'share in the reward of success' means that private individuals or commercial entities are removing taxpayer-funded money from the system.

17 Details on these issues and the evidence for them can be found in the Public Administration Select Committee's (PASC) report on "the Big Society": http://www.publications.parliament.uk/pa/cm201012/cmselect/cmpubadm/902/902.pdf

Case study

Goldman Sachs: commercial investment in PbR

It was recently reported that Goldman Sachs has invested nearly $10m in a social impact bond aimed at reducing reoffending amongst adolescent inmates of New York's Rikers Island prison[18]. The money is being offered in the form of a loan to the social services provider MDRC, which will design and deliver the programme of interventions. If recidivism is reduced by 10%, Goldman Sachs will get all of their $9.6m back. If the rate is reduced further, Goldman Sachs could stand to profit by up to $2.1m, while if the reduction target is not met they could lose up to $2.4m. MDRC will be offered additional security in the form of a $7.2m loan guarantee provided by the Mayor of New York, Michael Bloomberg's, personal foundation.

This deal has generated a huge amount of interest, as it is the first time that a major commercial player such as Goldman Sachs has put money into a PbR structure of this kind. If successful, it is like to become the archetype for future commercial investment in PbR.

In a perfect world, perhaps commissioners would be sufficiently tolerant of risk to invest in the interventions directly and thus get the direct benefits of savings too, but we are not in a perfect world. Despite numerous historical examples of the State supporting innovation and many pockets of forward-thinking commissioning practice, the public sector is generally highly risk averse. Hence it is necessary to find ways of reducing the risk of funding to an acceptable level and pragmatism dictates that it is necessary to look for innovative solutions. This may involve incentivising external investors by offering them the possibility of a financial return.

What about the not-for-profits actually delivering the services: do they stand to benefit financially from successfully delivery of results? In one sense, the answer should clearly be 'yes' because if a not-for-profit holds a PbR contract, it will get paid by the commissioner if it successfully delivers results. However, because many not-for-profits struggle to find the resources for effective contract negotiation and end up with unfavourable contractual terms, they may not even be able to recover their own full costs. But what if the not-for-profit actually outperforms in terms of the outcomes it produces – will it be rewarded proportionately? Currently this does not happen in most cases, so the benefit of outperforming targets goes only to the commissioner (through increased savings) or to the investor (through increased returns). CAF believes that it is important that not-for-profits are able to share in the financial upside of PbR contracts, as well as being protected from the downside.

18 http://www.nytimes.com/2012/08/02/nyregion/goldman-to-invest-in-new-york-city-jail-program.html

iii) Results

As the name suggests, results are at the core of PbR approaches. It was highlighted above that the trend is increasingly to talk about these results in terms of outcomes, but in many cases the reality of the commissioning process has not kept pace with this rhetoric. Most commissioners are still defining contracts in terms of features of the service they want to see provided, rather than the outcomes they want to see achieved. Even when commissioners claim to be using outcomes, they are in fact often talking about outputs. The question then is to what extent these outputs are effective proxies for the desired outcomes. If they are not good proxies, there is a real danger that the design of the service is skewed towards achieving these outputs, to the potential detriment of service users.

Social outcomes

It is perhaps not surprising that many commissioners have not yet fully got to grips with working with outcomes. The main challenge is that outcomes are just difficult – difficult to specify, often difficult to deliver and usually difficult to measure. This is of course, just as true for social investors and intermediaries, and this is something that commissioners must take into account. If investors and intermediaries are to be able to perform effective due diligence on PbR-linked social investment deals, they need to be able to gauge the risk associated with a commitment to deliver given outcomes, and in order to do this they need to have sufficient access to the data the commissioner has used to set the outcomes targets in the first place. Similarly, when it comes to measuring success against outcomes targets, the not-for-profit, social investors and intermediaries will have to put a significant amount of resource into monitoring and evaluation to ensure that interventions are on track to deliver the desired outcomes. Commissioners must be prepared to factor the cost of this measurement into the outcomes-based PbR deals they make.

One of the particular issues often cited with using outcomes is that it is hard to pinpoint with any certainty precisely which factors have caused an outcome to come about (*the attribution problem*)[19]. In particular, the more you focus on prevention, the bigger the gap between intervention and outcome, and the more problematic it becomes to ignore the influence of external factors. This can be a problem if you are proposing to pay someone for delivering outcomes, as you want to be certain that the intervention is actually playing a significant causal role in those outcomes coming about. Hence you need to know what would happen if the intervention did not take place, which means having a control group. This immediately makes it far harder to do anything at a large scale (and certainly not nationally; what would the control be?)

There are ways of working with outcomes though, and just because something is hard, that does not mean it is not worth doing. One potential advantage of social investment approaches to PbR is that they could help overcome or avoid the attribution problem. If an intermediary is responsible for ensuring that outcomes are delivered, rather than an individual charity or social enterprise, it means that the intermediary can 'invest' in a portfolio of interventions without having to specify exactly what 'percentage contribution' each intervention makes toward the achievement of the desired outcomes. This allows for there being some 'slack' in the system: perhaps activities are slightly duplicated or it is not clear whether all approaches are absolutely optimal, but that does not matter because the right results are achieved. The problem with this

19 An MoJ report analysing the Peterborough SIB project highlighted the attribution problem as one of the key challenges that had been faced in the development of the bond: http://www.justice.gov.uk/downloads/publications/research-and-analysis/moj-research/social-impact-bond-hmp-peterborough.pdf

is that public sector commissioners who are under pressure to ensure value for money might not be that happy with the idea that they are not getting outcomes at the cheapest price, and try to put pressure on intermediaries to remove any redundancy in the system. By doing this, though, they would fall into the same sort of trap that has led to the skewing of focus towards inputs and processes rather than results. The danger then is that you get efficiency, but at the cost of effectiveness.

Organisational outcomes

As well as the social outcomes produced for service users, there is the potential to deliver important organisational outcomes for the not-for-profits that receive social investment. For instance: developing investment readiness, so that the not-for-profit can access social investment finance much more easily in the future if required; or building contract management skills so that the not-for-profit is better placed to bid for and deliver future public service contracts.

The role of social investment intermediaries is absolutely crucial here as they have the potential to be a catalyst, but can also act as a barrier if the wrong approach is taken. If the intermediary takes all the responsibility for dealing with the commissioner and for other aspects such as measurement and contract management, the not-for-profit it invests in will not get the benefit in terms of organisational outcomes that they might otherwise have had.

The intermediary might well be acting with the best of intentions, believing that by taking on all the additional responsibilities they are 'freeing up' the not-for-profits to concentrate on delivering the interventions, but they could inadvertently be stifling their broader development. Given that lack of investment-ready organisations is often cited as one of the main barriers to the development of the social investment market, it is vital that when intermediaries make PbR-linked investments they look for ways to help up-skill the charities and social enterprises they work with at the same time. This might be something the intermediary does itself, or it may feel that it is more appropriate to bring in external resources. And of course it must be a collaborative enterprise, based on the not-for-profit's ambitions and needs, not something that is forced upon them.

Commissioners must also be willing to factor the costs of this broader development of not-for-profits into their contracts with intermediaries. Not only will it contribute to the growth of the social investment market, which is an explicit Government ambition, but it will also have direct benefits for the commissioner in terms of creating a larger pool of potential service providers.

PbR could represent a huge opportunity for not-for-profits. If implemented properly, the flexibility and freedom within PbR should allow not-for-profits to maximise their ability to innovate and deliver better services for users. Social investment can play a key role in overcoming some of the funding challenges that PbR presents, but as highlighted above there are a number of issues that need to be addressed if the full potential of PbR is to be realised.

Our recommendations

In order to address the challenges identified in this paper and fully realise the potential for social investment to support not-for-profits that take on payment by results public service contracts, CAF recommends that:

1 Social investors and intermediaries should ensure that any deals based on PbR public service contracts should be structured so as to enable the organisations delivering the contract to share in the upside, if targets are exceeded.

2 Social investment intermediaries and commissioners should look to up-skill the not-for-profits that they invest in, in order to develop the marketplace.

3 Commissioners should ensure that PbR contracts are not entirely end-loaded, but instead combine up-front payments, to cover some portion of the not-for-profits' core costs with at-risk success payments that are paid in arrears.

4 Commissioners should factor the additional costs of up-skilling not-for-profits into their funding for social investment models.

5 Commissioners must allow time in contracts for potential investors to perform due diligence on their investments in order to ascertain risks properly. If social investment is to be involved in funding PbR service delivery, the commissioning process must not present unnecessary barriers.

Charities Aid Foundation (CAF) and CAF Venturesome

The Charities Aid Foundation (CAF) is a registered charity that promotes charitable giving and provides financial services and social finance to not-for-profit organisations. We help donors – including individuals, major donors and companies to give more effectively whilst providing financial and fundraising solutions for charities in the UK and internationally, helping good causes to manage their resources more effectively. We also have a strong track record in research, policy and advocacy, working across a range of issues to ensure the best possible funding environment for charities.

Our pioneering social investment arm, CAF Venturesome has a 10 year track record of providing capital (debt and equity) to charities, social enterprises and community groups. Since 2002, CAF Venturesome has provided over £26m of capital to 300 organisations. CAF Venturesome manages several funds, including a thematic fund which supports the development of Community Land Trusts. It has recently been involved in a number of public service-related social investment deals.

To find out more about Charities Aid Foundation
visit www.cafonline.org

To find out more about CAF Venturesome
visit www.cafonline.org/venturesome
email venturesome@cafonline.org
call +44 (0) 3000 123 300

If you would like to discuss any issues raised within this paper or require further information about CAF's policy positions, please contact the author of this paper:

Rhodri Davies
Policy Manager
email rdavies@cafonline.org
call +44 (0) 3000 123 221

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