Pricing out Third Sector Organizations: The unequal outcome of the Freud Report

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Abstract

This paper argues that the modifications to the contracting process for UK welfare to work programmes instigated by the Freud Report, *Reducing Dependency, Increasing Opportunity: Options for the Future of Welfare to Work (DWP, 2007)*, reduce the involvement of third sector organizations (TSOs) in the delivery of employment services. Drawing on Neoinstitutional Economics the paper outlines the changing rules of welfare to work contracting which have led to increased transaction costs for delivery organizations, and the requirement of large amounts of upfront funding for the delivery of welfare to work contracts. The paper argues that these changes discriminate against TSOs which are not able to raise capital or borrow in the same manner as private sector organizations, and which are unable to manage the increased risk and larger transaction costs associated with such contracts. It uses case study research of a TSO to illustrate these points and to identify further management difficulties attributed to these administrative changes.

Key Words: UK welfare to work; Payment-by-Results; quasi-market; Case Study; Neo Institutional Economics

Introduction

UK welfare to work programmes are often administered through a quasi-market model emphasising competition between providers and payment-by-results. When promoting the market approach the UK government argued that the growing use of both private and third sector organizations (TSOs) is based upon their 'superior client knowledge' and 'innovative delivery methods' claiming that, 'these organizations can bring a distinctive approach to service delivery, based on their specialist knowledge, experience and skills' (DWP, 2006, p.74). This paper argues that whilst a large number of TSOs were involved in the early stages of the UK quasi-market, in recent years private sector organizations have tended to dominate the contract awards, due to the reforms initiated by the Freud Report *Reducing Dependency, Increasing Opportunity: Options for the Future of Welfare to Work (DWP, 2007)*, and in subsequent DWP market documentation.

It is argued that only a small number of third sector organizations (TSO) have successfully won prime contracts and delivered welfare to work programmes over the last five years, drawing attention to the complexities of competition and the role of TSOs in market based governance systems. Despite this, academic research into TSOs and the impact of their interactions with other organizations in the welfare to work market has so far been limited.

This paper draws on neoinstitutional economics (NIE) to explore the impact of market reforms on TSOs. It argues that understanding transaction cost theory (TCT) is particularly important for analyzing the market interactions, the decline of TSOs in welfare to work delivery, and the organizational change experienced by those seeking to compete. It uses a qualitative instrumental case study of a Third Sector Organization (TSO) known throughout as 'Albase', to illustrate the impact of market reforms on the management, activities and structure of the organization. This paper argues that the involvement of TSOs in the welfare to work market has been affected by two changes to the DWP's market model which were presented in the Freud Report. First, the market moved from a predominately service payment approach to a payment-by-results model. This increased performance based payments and transferred financial risk from the commissioning body to providers. This paper discusses the impact of these changes on management decisions for ALBASE and explores their approach to adapting to these risks. Second, the welfare to work market moved towards a prime contractor model. This involved reducing the number of contracts the DWP awarded for each programme by enlarging contract delivery areas and moving to a prime contractor supply-chain system. The paper demonstrates that there are sector level issues of TSO marginalization, and for ALBASE, the move brought to the fore issues of risk and organizational adaptation. By identifying costs associated with market involvement, the paper analyses at whether the move towards larger contracts and payment-by-result systems has introduced complex resource implications for the involvement TSOs in welfare to work delivery.

The paper is structured as followed. The first half of the paper outlines the case study, provides the necessary background detail of welfare to work contracting, and briefly introduces the modifications put forward by the Freud report. In particular, the emphasis on payment-by-results and selecting providers based on financial capacity. Included in this section is a consideration of how these changes have impacted on Albase and on TSOs more generally.

The second half of the paper asks whether the increased risk and preference for large financial prowess leads to TSOs being 'priced out' of the market, regardless of their experience and ability to provide employment support. In short, is the administrative structure of the modified market excluding TSOs from participating in the provision of employment services? It draws more explicitly on NIE to argue that the increase in costs associated with market involvement mean organizations without access to capital may find participation in transactions within the market more difficult. The paper concludes that whilst TSOs are promoted in policy rhetoric, in reality the modifications of the administration of welfare to work contracts in the quasi-market are marginalizing their involvement in the provision of employment support. As discussed, due to the costs associated with risk based transactions TSOs may find it difficult to enter or maintain their position within the welfare to work market.

Part one: Background to welfare to work, case study and NIE

In this section details are given about welfare to work contracting in the UK, the case study research and the theoretical framework employed. It begins with a brief introduction to the welfare to work policy context in the UK.

Based on the belief that individuals are better off in work (DWP, 2002), most UK employment programmes seek to move individuals claiming out of work benefits into the labour market through a series of job-search and support arrangements. Such programmes, referred to as Welfare to work programmes are often considered as a key part of an Active Labour Market Policy (ALMP[i]) approach and since the late 1990s they have been contracted-out by the DWP to be delivered by independent providers, such as private and third sector organizations[ii]. These independent providers compete and tender to deliver short-term employment programme contracts ranging from two to five years in length, emphasizing performance measurement and targets for results (Struyven and Steurs, 2005). Providers are audited, ranked and rated on their results, which are predominantly based on moving individuals off benefits and into the labour market[iii]. When promoting the market approach the UK government argues that the growing use of both private and third sector organizations (TSOs) is based upon their 'superior client knowledge' and 'innovative delivery methods' claiming that, 'these organizations can bring a distinctive approach to service delivery, based on their specialist knowledge, experience and skills' (DWP, 2006, p.74). 'They can also offer more scope for innovation, developing new and creative ways of working with customers' (DWP, 2007, p.7).

Further justification for the use of independent providers from the DWP claimed that, 'the contracting process will ensure quality provision, competition to drive value, out-come based contracts with the flexibility to drive value', (DWP, 2007, p.60). Through the use of market mechanisms the delivery of employment services should improve because introducing competition between providers should reduce inefficiencies and improve results. This market-based development in the delivery of employment programmes played a key part in the UK welfare reform agenda of both the previous Labour and continues to be supported and advanced by the current Conservative-led coalition Governments (see Davies, 2008, DWP 2010a) as part of a broader commitment to public service outsourcing.

From 1997 successive Labour Governments sought to develop the role of TSOs in the delivery of public services. This included a focus on the development of the sector's role in shaping and delivering public services and 2002 cross cutting review explored the ''value added'' aspects of the third sector. It suggested that the sector may have comparative advantage in terms of (HM Treasury, 2002), "specialist skills/ knowledge, the ability to involve people in service delivery; their independence and ability to innovate; their lack of institutional baggage; and their flexibility, responsiveness and (again) their ability to innovate" (Osbourne and McLaughlin, 2003, p. 577). The Office of the Third Sector[iv] (OFTS) was established in May 2006, aiming 'to develop and support an environment which enables the third sector to thrive, growing in its contribution to Britain's society, economy and environment''. To achieve this the government sought to increase partnership working (across government and within the sector); provide financial resources (including small grants and capacity building funds); introduce regulatory reform; and improve their evidence base (HM Treasury/Cabinet Office, 2007). The welfare to work market was a key policy arena where this transformation of the public and third sector relationship could take place. As such a number of TSOs are involved in the delivery of welfare to work services, such as social enterprises and charities which have previously been involved in employment programmes during the 1980's, 1990's and European Social Fund projects.

The development of the welfare to work market can be categorized into 4 phases (se Bennett, 2012). The first phase involved the creation of the market and a series of programmes and funds designed to build capacity in external organizations. The New Deal programmes introduced in the late 1990s instigated this phase which involved a number of consortiums between TSOs, public sector organizations and some private sector organizations being commissioned to deliver employment services. The second phase of the development of the market involved the introduction of the Employment Zone (EZ) which used a number of competing providers to deliver employment targets in areas of high unemployment in the UK, mainly large urban conurbations. The third phase involved the introduction of the Flexible New Deal (FND) in 2008 based on the recommendations of the Freud Report. Pathways to Work programme aimed at health benefit claimants included some of the propositions, including payment-by-results models and larger contracts. Finally, the fourth stage began with the introduction of the new Coalition Government's Work Programme in 2010.

The third and fourth phases are the subject of this paper. During these phases recommendations from the Freud report, *Reducing Dependency, Increasing Opportunity: Options for the Future of Welfare to work* (DWP, 2007) were implemented. The report suggested three amendments to the contracting system:

1. *Payment-by-results*:

   Based on an 'AME/DEL switch' process the paper argued in terms of public sector financial management that the funding for employment programmes could be achieved through benefit savings. Providers could be paid (DEL) based on the savings they make to social security payments (AME).
2. *A top tier of prime providers*:

   To reduce the number of contracts managed by the DWP the prime providers would be responsible for supply chains in their contract area
3. *Larger contracts*:

   It was proposed that contract be expanded to cover larger geographical areas, and more benefit recipient groups such as a range of health benefit claimants, lone parents and ex-offenders.

The modifications are designed to remove some costs for the DWP associated with designing, tendering and managing a large number of complex contractual relations. Furthermore, as Oster (2000) suggests, the change in governance structure may offer an efficiency gain as public agencies seek to off-load tasks into the less political and more single-minded corporate sector. However, changes to the administration of market mechanisms as outlined above also impacts on the accessibility of public service markets for would-be delivery organizations. These three modifications to the market are discussed in more detail throughout this paper as it considers what impact these amendments had on the composition and participation of TSOs in the delivery of welfare to work employment programmes.

To undertake a critical examination of these changes this paper draws on neo-institutional economics (NIE), in particular transaction cost economics. Neoinstitutional economists are concerned with the rule and governance systems that develop to regulate or manage economic exchanges. They are interested in developing and testing process arguments. Rather than treating institutions mainly as exogenous variables affecting economic behaviour, recent research has considered how institutions affecting economic transactions arise, are maintained and are transformed (Scott, 2008, p.27). The benefit of the approach in this study is the focus on the role of transaction costs. Williamson (1991, p. 103) defined transaction costs as, "the ex ante costs of drafting, negotiating and safeguarding an agreement and, more especially, the ex post costs of maladaptation and adjustment that arise when contract execution is misaligned as a result of gaps, errors, omissions, and unanticipated disturbances; the costs of running the economic system." Williamson argued that transaction costs increase when individual rationality (which is bounded) is confronted by heightened complexity and uncertainty, and when opportunism- some actors propensity to lie and cheat- is coupled with the absence of alternative exchange partners. Under such conditions, exchanges are likely to be removed from the market and brought within an organizational framework, or to stimulate the development of more elaborate controls (Williamson, 1975, 1985). North (1990, p.5) also directs attention to wider institutional frameworks- societal "rules of the game" and views organizations as "players" who are attempting to devise strategies to win the game (Scott, 2008, p.30). Exchange between the market units therefore must be organized and regulated. Yet these activities involve real resource (transaction) costs and if we assume economizing behaviour, economic institutions (governance structures) will evolve to minimize these costs of organizing resource allocation. But the evolution of institutional arrangements may involve other factors than just a minimization of transaction costs. Equally, as appears to be the case with the welfare to work quasi-market, institutions (such as the DWP) might evolve to facilitate changes in the units themselves (Dietrich, 1994, p.9).

Bearing this view of transactions and how economic exchanges can shape organizations, the paper uses a single (instrumental) case study of an organization based in the UK delivering welfare to work programmes. The organization is a registered charity which depicts itself as a social enterprise. It has been renamed as Albase throughout this paper for ethical purposes. Albase has been active in the delivery of employment programmes for over 25 years, and has won contracts to deliver a number of the New Deal programmes, the Employment Zone, the NDDP, the Flexible New Deal and narrowly missed out on the Work Programme contract. The research is based on document analysis of DWP tender and contract information, the bids submitted by Albase, interviews with key past and present management employees of Albase, a short ethnographic study within the organization, and the analysis of internal business planning and management documents. All texts and respondents have been anonimised throughout the paper. The case study will allow an in depth examination of how changes to their environment (the quasi-market) can impact on the activities of a TSO.

The remaining part of this section is structured in the following way. First, the paper will discuss the changes to the way in which providers are paid for moving individuals into employment, namely the payment-by-results model. Based on Albase's experience this is followed by a consideration of the impact of this model on business planning and management. The second issue covered is the move towards prime providers and the selection criteria which gives preferential treatment to financial prowess. This is followed by a discussion of how this impacts on TSOs more broadly in the market, and using research on Albase, it argues that the prime provider system raises issues of power and control within the quasi-market framework. Section two moves on to consider whether TSOs are being priced out of the market.

Payment-by-Results

Payment-by-outcome is a broad term to refer to a form of performance management where providers are paid on the basis of outcomes (Sturgess et al, 2011). The approach is often considered as a high-stake form of performance contracting and is a key policy instrument in the NPM approach to public service reform. In the UK it is currently known as *payment-by-results* (a phrase preferred by the current Conservative led coalition government) and replaced the term *outcome-based commissioning*, which was the favoured term by the previous Labour Government, although in practice there is little difference in the approaches used by either administration.

In the UK welfare to work market payment-by-results plays a key part of the reforms to the administration of employment programmes, as it is used to direct and measure the performance and financial reward of contractors who are able to meet the short-term targets outlined by the DWP. In this format payment-by-results is employed in conjunction with performance contracting; that is, it is associated with a public sector commissioner purchasing specified outcomes from an independent or semi-independent provider from the public, private or third sector. Whilst a similar 'management by objectives' (see Sturgess *et al,* 2011) approach may operate between departments within the public sector focussing on the achievement of results, it will rarely involve the transfer of payments and therefore differs from the system set up with external contractors.

In welfare to work contracts providers previously received two main types of funding; performance linked and non-performance linked. Performance linked funding was and continues to trigger a payment to the contractor once an agreed milestone is achieved by the job seeker, most commonly the move into the labour market. In some contracts there are also payments if the individual maintains in the labour market over a specified time period. For example, in the UK Employment Zones, if providers ensured jobseekers retained work for both 13 weeks and 26 weeks they were eligible for outcome payments. In addition, they were also required to obtain work for a certain percentage of jobseekers referred to them in order to be eligible for a bonus award. In the Work Programme job seekers have to remain in work for up to two years for providers to receive the bulk of their performance linked payments.

The second type of funding, non-performance, is a lower value than performance linked payments and is awarded when the individual signs-on with the organization (known as an attachment or referral fee). In the New Deal programmes contracts the provider also received on-programme fees once the individual has been with the organization for a specified period of weeks. The non-performance payments were seen by providers as a crucial part their business plan providing the funding for overhead and running costs during the contract delivery phase, particularly in the earlier programmes such as the New Deal and Employment Zone as these payments helped build and attract providers which strengthened the market. However, over time the bulk of contractors' payments have become increasingly weighted towards performance linked payments. This development is most evident in the Work Programme which adopts an 'invest-to-save' approach requiring providers to finance a substantial proportion of the up-front costs of service provision, with reimbursement being made later out of identified savings to the treasury[1].

Within the payment structure, three types of performance linked incentive schedule can be identified which have been used in the design of welfare to work contracts; *thresholds, distance travelled and milestones (*Sturgess *et al*, 2011)*.* Each type of incentive schedule affects the behaviour of providers and the relationship between the DWP and the contractor. *Thresholds are* strict standards in which providers receive no reward until a certain level of achievement has been reached, such as 30% of the contract population. Although the threshold approach is not used on its own in the UK, the broad threshold principle frames much of the welfare to work contracting as providers who do not meet their targets at specified dates may lose their contracts or a percentage

[1] "A Departmental Expenditure Limit (DEL) comprises spending which "can sensibly be controlled". It is a "firm limit" for the department's spending set over a three year period following a Spending Review. Annually Managed Expenditure (AME) covers spending which the Treasury argues cannot sensibly be planned in advance, and which is set annually in the relevant Budget" (See A4E, no date)

of their referrals. Conversely*, w*ith *distance-travelled* standards, the aim is to reward incremental improvement and the approach is often associated with programmes working with those furthest from the labour market which advocate the use of distance-travelled standards. In such programmes providers are be rewarded for improving an individual's employability, rather than for labour market attachment rates. Employment programmes that have used this approach have tended to work with health-benefit claimants and used condition management based programmes. Finally, *milestones* can be used with intermediate outcomes, in which case they signal progress against a distance-travelled measure, or reward outputs on route to a primary outcome. They tend to be associated with programmes which are designed to measure progress that commissioners value and choose to reward, such as a payment for the completion of a training course. Milestone payments may also serve to motivate providers to work with disadvantaged clients who may not meet the final standard but will nevertheless achieve some of the benchmarks and trigger a payment. In some cases they provide early evidence of performance and thus help commissioning bodies to overcome problems of under performance. For example, in the FND programme, providers received payments when jobseekers were placed in a job and then when they retain work for 13 weeks, even though the primary focus was on ensuring that clients remained in employment for 26 weeks. These milestones are considered valuable enough to the commissioning body to be worth rewarding, perhaps because they provide evidence of cost savings. The approach may also be used to reduce performance risk for providers or to assist them in dealing with cash flow problems. In practice between 1999 and 2010 welfare to work programmes have used a mixture of incentive options as part a continual 'adaptive contracting' approach adopted by the DWP.

However, as argued in this paper adopting a payment–by-results approach and weighting payment schedules towards performance linked payments is not without criticism. It has already attracted attention from those who are concerned with the service provided to those furthest from the labour market. Despite sometime complex payment schedules designed to influence contractors' delivery behaviour, in almost every scheme involving payment-by-results, there have been concerns that providers would engage in 'gaming'; either focusing support on individuals closest to the labour market (creaming), or offering only the minimal level of help to those unlikely to provide a profitable job outcome (parking) (see Finn, 2011). Evidence from schemes such as Pathways to Work also suggested that when the financial viability of providers is most strained, providers target their provision most strategically (Hudson *et al*., 2010). Whilst attention has been given by academics and commissioning bodies to problems associated with provider behaviour in terms of gaming and the incentive strategies, much less has been directed towards the management behaviour within organizations that operate in a payment-by-results market. In the following section we consider how Albase manages the payment-by-results process and what impact it has on the organization?

Managing payment-by-results

For the Albase the payment-by-results model presents a number of risk-based issues. This includes future business planning, the management of uncertain financial payments, and estimating performance offers. These issues arise because service providers pay for the delivery of a service and receive payments based on outcomes. As such, most providers will only receive payment and generate a cash flow part-way through the delivery of a contract and once some outcomes have been met. Whilst all of these factors are equally a concern to private sector organizations, as explained below the impact that they have on TSOs, such as Albase is more acute. Each issue is discussed in turn below.

First, a problem with the payment-by-results policy for providers is the lack of transparency of referral figures and how it translates into income during contract delivery. This affects business planning as future growth is difficult to plan. This is particularly acute in regards to the larger contracts, such as Flexible New Deal (FND) and the Work Programme, with an expected five year contract length, and which are accompanied by longer procurement processes lasting up to 18months. In terms of these programmes Albase experienced increased levels of uncertainty. This is because during the business planning stages of these programmes, the expected turnover amounts are unconfirmed and managers are not able to confidently undertake forward planning and business development. For TSOs which are seeking to become established in the welfare to work market uncertain income streams make investment in internal functions to "build capacity" especially difficult. For example, Albase secured a large contract for the delivery of FND Phase 1 in 2009, which was originally valued at £138 million based on an anticipated 90,000 customer volume. However, due to a revision of the referral volumes after one year, the contract value was re-valued at approximately £80million over the 5 years.[2] This was also an issue with the EZ contract where the organization reported that, "the Employment Zone is now fully imbedded and has produced £1.3million of additional income over 2005, although this has been largely surplus-neutral since the numbers of client flowing through the zone have been much smaller than we were led to believe would be the case by the DWP[3]." However, with EZ Albase also received distance travelled and milestone payments.

As delivery organizations in recent years have been expected to fund the early years of service delivery and receive payments two or three years into the contract, the lack of transparency of service provision presents an extra risk consideration for the delivery of longer contracts such as the five year FND 1 programme and now the Work Programme. During the first year of the FND 1 contract there was an increased necessity that the referral numbers expected during the bidding stage translated into actual jobseekers to provide some cash flow for delivery organizations. Similarly, providers required some of these jobseekers to enter employment. During this time the organization experienced maximum financial exposure as they were spending money on service provision based on service user number predictions, and the anticipation that only some of those users would enter employment. The organization termed this a 'depth of risk issue,' during the first year of the FND contract due to this extra degree of risk.

A second and related issue that affected Albase's financial planning was the payment timing. The payment-by-results model required each contractor to invest their own money in the earlier years of the contract and only hit even and then make a profit in the latter years of the contract. This increased the length of risk exposure for Albase. For the 5 year FND model the organization expected that the cash flow would not start to become positive again until approximately three years into the contract, with profits expected in the final 20-24 contract months[4]. This was described as a 'length of risk' issue where Albase would be exposed to risk for a number of years as the early stages of the majority of services required for contract delivery were self-funded.

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[2] 2009 business strategy plan
[3] 2006 strategy
[4] *The FND was cancelled in 2010 when the Coalition government took over and FND contracts only lasted until 2011 rather than 2014 as expected.*

As such, programmes such as the FND and the Work Programme which require each provider to "cash and pump," a large amount of up-front capital are financial difficult to manage. The design relies on both the availability of capital in the early stages and the possibility of more cash during the delivery stages if the business plan and expected referrals and job entries cannot be maintained. In the words of one respondent, "you really need deep pockets to do that[5]." The financial risk is intensified for TSOs, such as Albase, who are required to find the cash flows necessary to fund the early parts of the contract and to maintain service delivery during the contract lifetime. Albase, like many TSOs did not have the option of raising cash through other sources, such as investors, shares, or the market.

Third, an underlying principle of a payment-by-results approach is to reduce the costs of delivering a service by only paying for those where a saving has been made (i.e. paying for employment support in the anticipation of reducing future, more expensive, out of work benefit payments as seen in the Work Programme). To select a contract winner, providers put forward a performance target or offer which outlines the number of jobseekers they would move into the labour market and ultimately what savings they would make for the commissioning organization, the Government. In order to win the contract and provide the lowest priced bid, each organization offers the most competitive performance target. For example, whilst the commissioning body may suggest a minimum target of 30%, after receiving the bids the DWP may then chose whether to award organization A the contract worth £20m offering 35% performance target or organization B who claim that for £20m they will get 40% of people into employment. In this most basic example, during the tender phase the bidder decides on a performance figure which they consider as achievable in terms of delivery cost, their knowledge of the labour market, and unemployment knowledge of the delivery areas. The performance offer device aims to ensure that the contract winner is the organization who has claimed to achieve the required targets for the largest proportion of the client group, and therefore at the financial best value.

One issue with this approach for delivery organizations is the problem of 'winner's curse,' (Cumming, 2011) where the winner bids a price/service package that it is not able to deliver or assumes risk that it is not capable of managing. This is possible because many of the welfare to work contracts require the bidding organization to state their performance rate (expressed as a percentage) of the target group identified in the tender document, which may be based on a service or client group which is unfamiliar to the organization and/or the commissioning body. Similarly they may identify a business model and then decide on what performance offer would meet their turnover expectations. From exploring Albase's experience it appears that the performance offer decision is, however, a complex one. A hierarchy of tensions is identified based on this aspect of the contracting process and outlined below.

First, there is often a tension between the providers and the commissioning body. Providers, aware of the business risks, may prefer performance targets or standards which they consider 'realistic' in terms of their business capabilities. On the other hand commissioners would like performance offers to be stretching so as to encourage innovation in the market, and go further to address the public policy issues they seek to target. The difficulty occurs when the negotiations have produced targets which are too stretching and undeliverable, producing a case of winners curse. For example, in the UK's Pathways to Work, the commissioner established the standard for clients remaining in work at

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[5] Respondent 3

26 weeks, while providers competed to set their own monthly targets for numbers of job and sustained job outcomes. The conclusion was that contracts were signed at levels of performance that were unachievable as providers were unable to supply the numbers of outcomes anticipated, and thus faced severe cash-flow problems. As such 'winners curse' was the outcome of an underestimation of realistic service needs and the associated costs which may occur. With the increased competition outlined in the Freud Report, the likelihood of winners curse is increased as providers are dealing with more benefit groups which have not been involved in welfare to work contracting previously.

Second, there are competitive pressures created within the market through provider discussions which influence the perceived minimum performance rate put forward in provider submissions. Providers generate their performance rate through the consideration of a number of factors such as; the local economy, client group labour market rates, their relationships with employers, their experience with the client group, and so forth. The competitive pressure created by the need to put forward a better performance rate than other providers is an added factor that increases the performance rates declared. In practice, whilst providers avoid discussing performance rates with each another it is possible to get an approximation of competitors' offers during discussion in the tendering stage either through networking events or official partnership discussions. For example, Albase during sub-contractor discussions for one welfare to work programme received performance offers and figures that competitor organizations required sub-contractors to deliver. Albase were able to identify a performance zone through "number crunching" and identify an approximate performance target for each bid. Albase could estimate that, "people [other contractors] were going kind of roughly between 45 and 55% of people into jobs" and could factor this into the decision for their performance offer. Whilst increased performance offers through competition may be an intended outcome for the commissioning body (as it may create service innovations by providers desperate to meet their inflated performance rates), for Albase it created unknown business delivery and management problems during the bidding phase as offers were not wholly based on service delivery expectations or capabilities. It increases the problems of imperfect information as bidders put forward propositions in their tender offers which they may not consider realistic and were not originally part of the tender offer from the commissioning body.

Finally a tension, which has not yet been identified in welfare to work literature, appears to occur *within* organizations such as Albase where there are competing agendas influencing the performance figure put forward. In Albase it appeared that difficult decisions were required when the delivery team identified a lower performance rate than the development team. This may have been because the delivery team was aware that they would have the responsibility to achieve the future performance target and therefore suggested a performance outcome based on their front-line experience having previously or recently delivered a similar contract with the client group. In contrast, the development team had attended presentations by the DWP which stressed the importance of higher performance offers, attended meetings with competitors, and feared the possibility of being outbid by rivals. They were more aware of the institutional environment and competitive pressures. There were also individuals within the organization (such as the finance director and the CEO) who had a responsibility to ensure that activities undertaken by the organization were cost-neutral at worst, but were ideally producing a surplus that could be reinvested in the organization. As such the performance target decision was not purely based on the cost of delivering the required services to the DWP as outlined in the contract, but was influenced by the competitive behaviour of others within the market alongside the availability of labour market knowledge, and the perception of business gains and risks. As such, a number of difficult internal business management decisions regarding the performance offer were required. In short: "*It's not simply we can't, even if we wanted to be realistic and say, we choose 20% performance because we think that's all we can get this current market place. 20% output based funding doesn't actually give you a business*"[6].In response to the concern that the development team may successfully win a contract which the front-line team could not deliver ('winners curse'), senior managers restructured the organization and brought the responsibility for the management of development and delivery under the same manager to reduce the risk of failure, "*I don't want to be caught by someone saying, you're winning contracts but they're undeliverable. So it looks good for you in March but we look terrible in October.*"[7] Consequently, the decision making process for the performance offer highlights three operational concerns regarding the associated financial risks of the contract: a) winning the contract but not achieving the targets; b) winning the contract, achieving the targets, but not making enough surplus to reinvest in future contracting processes; and c) not winning the contract and therefore missing a resource opportunity which may hinder future contract awards.

For the DWP, payment-by-results was part of an effort to reduce the transaction costs incurred by the DWP in the tendering and management of welfare to work contracts. For Albase, the payment-by-results contracting approach presented a new organizational challenge to the organization, as the process for gaining resources had been altered and they needed to respond. In order to reduce the risks associated with misunderstanding the requirements of each contract and performance offer, the organization was forced to change its internal structure. As such the payments-by-results and performance offer policy tools directly encouraged the restructuring of the organizational structure, management processes and approach to resource acquisition towards a set-up more suited to the contracting environment.

The second major change to the market was the introduction of prime contractors. As previously outlined the Freud report advocated the use of larger contracts to a core number of prime providers, thus reducing the number of contracts the DWP had to manage and procure, and reducing the frequency of transaction costs involved in the procurement of services in the market. The following section identifies the impact of the introduction of a prime contractor model for the activities and structure of Albase.

Along with the move towards a payment-by-results model the DWP changed the structure of the market and introduced a "prime contractor" model in 2008. The idea was to award contracts to large organizations at the regional level, which in turn, award sub-contracts to smaller, specialized, local service providers. The move towards a model based on "prime contractors" was intended to reduce the numbers of contracts that DWP directly oversaw, and as a consequence was expected to reduce administrative complexity and costs for the Department (Work and Pensions Committee, 2009, p. section 37).

In order to avoid the emergence of monopolies, the contracting rules in the FND stipulated that there ought to be at least two prime contractors in operation in most regions. These market reforms were continued by the Coalition through the introduction of the Work Programme which expanded on the earlier prime contractor idea by amalgamating a number of FND contracts into regional 'lots' across the UK. The Commissioning Strategy (DWP, 2008) that the Work Programme prime-

[6] Respondent 5
[7] Respondent 5

contractor model would lead to the creation of a strong market structure in which 80% of the Department's business would be conducted with a "stable core of reliable providers" led by prime contractors at the regional and sub-regional level.

A notable change to the market was the introduction of a Preferred Suppliers Framework (known as the Employment Related Support Services ERSS framework, DWP, 2010c) as a pre-bidding phase for the Work Programme in 2010. The framework was designed to create a list of providers who would be able to bid for the incoming welfare to work contract (the Work Programme) as a Prime Providers, taking the responsibility of managing supply chains in a given area. Only the organizations on the Framework would have the option to bid for future welfare to work contracts as prime providers and possibly a number of other public service contracts expected in the future. The framework emphasized the importance of financial capacity above all else by introducing a minimum turnover threshold for competing bidders of £20 million per annum, assessed at a pre-qualification stage.

> *"We would not expect to place organizations on the ERSS Framework whose current turnover is less than £20 million per annum unless such organizations can provide during the competition robust evidence of their ability to manage within these anticipated financial constraint".*
>
> (DWP, 2010c, Para.1.3.3)

The scoring mechanism for the Framework was weighted towards rewarding organizations with supply chain management experience, access to large financial resources and contract performance knowledge. Potential providers were assessed through the introduction of a "growth capacity model", "acid ratio" and "debt ratio"[v] in an attempt to asses the financial capacity of bidding organizations. This approach emphasized financial performance and contract management as, "the appropriate mechanisms…to continually drive up performance" (DWP, 2008, p.42). This step by the DWP to identify prime contractors based on their financial capabilities was a clear move away from claiming to use independent providers for their superior client knowledge and innovation (as was stated during the New Deal and Employment Zone phases) towards a use of providers for risk transference and contract management cost reduction for the DWP.

One of the key operational changes associated with the creation of prime contractor supply chain is the increased discretionary approach in the sub-contracting arrangements of prime providers. In practice the prime contractor will bid on a tender and inclusive in their bid is the role subcontractors will play in the delivery of services within the specified location. It is the responsibility of the prime contractor to design the involvement, relationship and the separate legal agreements with subcontractors in their bid. As such the DWP only makes a contractual agreement with the prime contractor and expects the prime contractor to manage their supply chain relations, performance and complaints.

Whilst transaction costs are reduced for the DWP as they have less relationships and contracts to maintain, transaction costs increase for some prime contractors and most subcontractors. This is due to the individualized supply chain and programme design of each prime contractor which requires subcontractors to negotiate and adapt their services to fit the needs of each bidding prime contractor in their operating area. For example, a mental health charity in Aberdeen may provide pre-employment support for job seekers with mental health issues. Prime providers may want to include them in their supply chain and refer a percentage of mental health claimants to their services if they win the bid. Difficulties arise when each prime provider bidding for their area (which on average for the FND and Work Programme was between 4-8 prime providers) has a slightly different employment support model, may identify shorter or longer support time periods than the organizations services currently operate, and each may differ on the referral percentage on offer. For each bid the TSOs management team would need to draft not only an agreement with the prime, but devise an internal business model to see whether they can operate a programme under the boundaries specified in each bid. This approach raises issues of transaction costs or business acquisition costs for each of the bids, which cannot be recovered from the contract service fee (as the prime contractors will do) as they do not have control of the profit-making part of the business model.

As such, costs and the associated risk are substantially increased for those subcontractors who have agreements with a number of competing prime contractors and whose bids may be based on different payment and delivery models. Concerns have been raised regarding the tendering process and the role of TSOs in private sector prime contractor bids prior to the advanced prime contractor model of the Work Programme. For example, although 44% of subcontractors for Pathways to Work were TSOs, not all primes intended to subcontract, and many relied heavily on informal service arrangements rather than official contracts (NAO 2010a). Similarly, TSOs have expressed concerns that primes would use their position to increasingly monopolise provision in house, removing provision from smaller third sector organizations (WPC 2007) and reducing opportunities for TSOs that existed previously. Evidence to the Work and Pensions Committee, also reported concerns ranging from a lack of referrals to malpractice by primes, such as late payment, or subcontractors findings themselves frozen out from delivery after contracts had been awarded (WPC 2010, 2009).

Furthermore, the supply-chain model highlights the disparate financial and organizational capacity of TSOs to negotiate with private sector organizations in the first place. Many small delivery-focussed TSOs do not have specialised bid writing, legal and finance teams. Their organizations may also lack the time and capacity to keep abreast with policy developments, negotiate the subcontractor agreements or plan future business which may be an unknown format (such as the payments-by-results format), whilst maintaining their day-to-day service activities.

Private sector providers welcomed the move (CBI, 2009) towards the prime contractor model which created larger 'chunks' of market share and the opportunity to generate larger profits and oversee larger delivery contracts than had been on offer in previous phases of welfare to work programme contracting (such as the New Deals and Employment Zone contracts). However, this involved a move towards replacing the relationship between smaller service providers and the DWP, to new relationships between service providers and prime providers. As such, the creation of a hierarchy of welfare to work providers through the supply-chain format affected the power structure within the welfare to work market between private sector organizations and TSOs.

In the same way as the DWP can leverage its monopoly through changes to contracting requirements and initiate changes and control over numerous contractors, the introduction of the prime contractor creates a second tier of organizations (primes) with increased power over subcontractor organizations. Operating across governance boundaries (i.e. the move from state controller to prime controller) has the potential to exacerbate contracting problems as organizations struggle to understand one another's incentives and corporate cultures. Prime organizations are now the gatekeepers to DWP funding. As the number of large primes are reduced those which are left have an increasingly influential role in negotiating service funding and policy content for employment services.

One key area of concern for Albase in the new supply chain arrangements was the government's conception of the role of private sector organizations and TSOs in the new prime contractor model. As the market expanded and the supply-chain format was introduced there was a broader re-definition of the role of TSOs and private sector organizations in the welfare to work market. Albase was concerned prior to the introduction of the FND that the market was moving towards a preference of larger private sector organizations in the role of prime providers.

"An increasing emphasis is being placed on large-scale 'national' providers as a procurement preference and this could act against us. At this point it is not clear if we are seen as sufficiently 'large' enough to be a preferred organization."[8]

Despite the diversity of the size, structure and activities of TSOs involved in the delivery of previous welfare to work programmes, increasingly TSOs have been pigeon-holed into the subcontractor role. The supply chain format appeared to encourage private sector organizations with contract management experience (rather than employment support experience) into the prime contractor role and TSOs and delivery organizations further down the supply chain. In 2009 (during the FND programme), a survey of DWP providers found that 44 per cent were from the third sector, compared to 25 per cent from the private sector and 31 per cent from the public sector (DWP, 2010b p.22). However, recent developments with the Work Programme saw a decline in the number of third sector organizations securing welfare to work contracts. In the Work Programme contract awards, approximately 72 per cent of prime and subcontracting arrangements were awarded to the private sector, with the third sector acquiring only 19.4 per cent, despite many of the bidding TSOs in possession of welfare to work experience gained over the past decade.

In fact, 35 out of 40 (87 per cent) available prime contracts within the Work Programme were won by private sector organizations, with only three awarded to TSOs organizations[vi]. Based on DWP volume predictions published in the tendering information for the contract, this equates to only 7 per cent of market share in prime contracting. It represents a significant decrease in the role of TSOs as contractual delivery partners with the DWP.

In response to these contracting results, Chris Grayling the Minister for Employment stated that the third sector remained involved in welfare to work programme delivery, even if they were not represented at the new prime contractor level.

> "*The Work Programme will also mean a multi-million pound investment in the voluntary and community sector over the next five years. Our list of preferred bidders includes impressive third sector involvement with nearly 300 third sector organizations involved in delivery of the Work Programme as sub-contractors, and two as prime contractors*" (Grayling, 2011)

This suggests that although the proportion of third sector prime contractors declined, TSOs may still be involved in providing services through sub-contractor arrangements underneath the successful private sector prime providers. However, a further examination of the contracting awards revealed

[8] 2006 Strategic priorities

that only two private sector prime providers involved the third sector in 50 per cent or more of their delivery strategy. In fact, of the 37 contracts awarded to private providers, 30 involve the voluntary sector in less than a third of sub-contracting arrangements. Furthermore, 16 of these involve the third sector in 10 per cent or less. Subsequently, in this phase of welfare to work market development, the contracts appeared to be unequally distributed amongst private sector and third sector providers, suggesting that there has been a shift of resources within the market towards the private sector organizations. This is particularly noticeable in comparison to the higher level of involvement of the third sector in earlier phases on welfare to work contracting.

The results suggest that the role of TSOs in welfare to work market is increasingly precarious. Even for those organizations outlined in winning bids there are concerns that both the financial pressures of the programme, and the frequent position of third sector subcontractors as specialist providers, will only receive referrals for the individuals furthest from employment and who are least likely to trigger an outcome payment (Hudson et al., 2010, WPC 2010). Furthermore, whilst the DWP created a financial structure to provide some funding to prime contractors at the referral stage (a one off small referral payment to the prime contractor), this is not always replicated in prime contractor supply chains. In 2010 the NAO reported that only three quarters of primes passed on the flat rate of payment even to specialist contractors and over half of subcontractors were not in a position to cover all of their costs, especially small third sector organizations (NAO 2010a). Although some relationships were rated as positive overall, only 38% of subcontractors claimed they would sign up to the same terms again.

This distinction between expected roles of private sector organizations and TSOs has meant that only a small number of TSOs have successfully won prime contractor roles. Albase was one organization to do so winning the FND South Scotland bid and latterly being one of only three TSOs accepted onto the Framework for the Scotland and North East England regions. It unsuccessfully competed for the Work Programme contract for the Scotland Lot in 2011. Although the number of TSOs competing at the prime contractor level has become less, the experience of organizations such as Albase in this role is increasingly important.

Power and Control

ALBASE did not experience the concerns highlighted by smaller, issue-based TSOs regarding negotiations and transfer referrals previously discussed. Due to the organization's history and development, Albase found the negotiation process less complicated than some other TSOs may have because Albase's involvement in previous rounds of welfare to work contracting had allowed the organization to grow and develop in line with the requirements of the market. Their presence in the employability delivery sector over a large number of years and their relationships with other organizations allowed the organization's management and development team to develop welfare to work market negotiation skills and in many cases competing organizations approach Albase to offer partnership opportunities. Nevertheless, the decision to be a prime provider was influenced by considerations of power and control within the system.

ALBASE decided to compete in the prime contractor role at the FND phase (and latterly in the Work Programme tender), in part due their belief in their ability to operate in the role of the contract manager, but also because they identified a number of perceived negatives to adopting the sub-contractor role. First, there was an awareness of the new power-based relationships that the supply-chain structure would create:

"The debate with the board and some of the early work we were doing was, could we fit into that as a prime contractor, or should we accept that bigger players were coming in, and our role was a subcontractor? Now, part of that was a financial consideration, but it was also about, can we control the contract? And if we accept for FND1 Phase 1 that we are squeezed as a sub, down to the subcontractor level, then it would be difficult to get out of that. So for various reasons we chose to bid as a prime contractor[9]"

The decision for the organization centered on weighing up the issues of control against issues of financial risk. Their understanding of the current market arrangements and the future market arrangements under the prime contractor model encouraged the organization to chose between remaining a, "*small player in a reasonably specialized employability area or go along and compete with the bigger guys…win a couple of those big contracts and fight the battle there[10]*." There appeared to be an awareness of the risks involved in becoming a prime contractor in terms of financial uncertainty which they assessed in opposition to the risks involved with being under the control of a private sector prime contractor. As one respondent said, *"financially, it was quite a risky strategy, but also it's quite risky not to go for it as well[11]"*

Second, respondents felt that the role as a subcontractor would also be detrimental to the organizations development and continued transformation into a competitive public service delivery organization. Respondents noted concerns about managerial and employee 'deskilling' if the contract management role was no longer their responsibility. Thinking ahead the organization's choice was not just a decision for the FND contract in 2008, but also as to what role and how much choice they wanted for future welfare to work programmes based on the investment they had previously made in the organizations management capacity. These choices were influenced by an understanding of the development of the prime contractor model in future tendering rounds.

Third, respondents mentioned concerns regarding the impact of being a subcontractor on the organization's approach to welfare to work programme content and the design of services for job seekers. "*In discussions with various other potential prime contractors, we realized that we had the potential to lose control of how we delivered the programmes if we went with them… there was a risk that if you went with another prime contractor you had to do it their way[12].*

Finally, the organization was aware of the informational advantage (build on) that prime contractors for the FND would have in future welfare to work contracting, and feared that becoming a sub-contractor at this point would limit their ability to try to become a prime contractor in future tendering events a core department would not be able to continue to adapt to DWP requirements.

"It was also the fact that the prime contractor, had we been a subcontractor, would be controlling the financial side of the contract, possibly the IT, probably performance management. And therefore, we would lose the capacity in those areas, to manage those aspects ourselves. And at the time we had an investment plan to improve out IT, our internal organizational capacity processes to manage

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[9] Respondent 7
[10] Respondent 3
[11] Respondent 2
[12] Respondent 7

contracts, because we were managing other contracts, and we were managing other supply chains, where we had experience of performance managing other subcontractors[13]".

So far we have seen that the changes to contracting have a number of implications for TSOs and that the more recent welfare contracting following the recommendations of the Freud report appear to have favoured the private sector providers as both primes and sub contractors. However, as we briefly touched upon above the changes to the contracting may also have influenced the future involvement of TSOs as those currently outside the market are unlikely to generate the finances needs to compete in the financially risky and expensive new welfare to work market. Whilst the role of TSOs in a payment-by-results and supply chain model has a number of risk-related barriers to TSO involvement, recent developments in the welfare to work market have also increased basic costs for involvement which further hinder the likelihood of TSO involvement.

Part Two: Are TSO's being priced out of the welfare to work services?

The introduction of and continued development of contractualism in the administration of welfare to work programmes introduces and increases a range of costs for providers that then impact on the design of the organization. As the welfare to work market has developed, the financial and personnel resource required from providers has increased. Using the experience of Albase these costs can be grouped into three categories; business acquisition costs, market participation costs and transaction costs associated with managing a contract. The acknowledgement of these costs and organizational developments highlights the complexities of TSO involvement in the welfare to work market.

The cost implications of any contractual agreement are most commonly discussed as 'transaction costs.' Transaction costs are an important component of any contracting process, and their implication in public service markets is a key factor in government efficiency debates. Transaction costs are essentially the management cost (in this case inclusive of risk and upfront capital) associated with either internally producing the service or buying it through contracting- the "comparative costs of planning, adapting, and monitoring task completion under alternative governing structures" (Williamson, 1981, p.552-553).

For the DWP contracting out the delivery of welfare to work programmes initially created transaction costs based on the writing of specifications and contracts, evaluation of tenders, publicizing the call for tenders, providing information and responding to enquiries from possible contractors and negotiating the final contract with the winning tender. There are also the on-going audit and compliance costs for the DWP of ensuring that the delivery organization fulfils the contract requirements. The rationale from the DWP for the move towards a payment-by-results and prime-contractor model was to reduce its transaction costs to avoid the danger that growing transaction costs may negate any financial benefits of contracting and reduce support for the contracting-out approach. The shift towards the payment-by-results model where payments to providers can be assessed against the future savings of benefit payments to the job seekers, tipped the balance firmly towards contracting out. This was because the cost of service provision and the success of achieving the policy goal were transferred to the external provider. The DWP's prime contractor format was also an attempt to reduce transaction costs that were incurred by the organization through the

[13] Respondent 7

arranging and monitoring numerous contracts and organizations. The move towards a top-tier of prime providers meant that the DWP were only directly responsible for a small number of contracts and in theory this reduces their transaction costs.

According to Coarse (1937) and Williamson (1981, 1996) the DWP will experience an increase in transaction costs from issues of limited information and uncertainty as parties to a transaction cannot fully predict all possible future scenarios and as such, they cannot fully specify contracts. As such, commissioning bodies may be unable to predict contractor opportunistic behaviour and as such they may need to engage in more pre-contract preparation and post-contract oversight-high transaction costs- to mitigate vendor opportunism and improve compliance. This is particularly important with public sector contracting where there are additional concerns over the management of public money and the contract value for the Work Programme for example, is estimated at over £100m for many of the lots. In short, the greater the financial reward from contracts, the greater the costs associated with awarding and monitoring a contract. For example, the DWP procurement process for programmes such as the FND and the Work Programme each took over 12 months and involved much preparation and information gathering for bidding organizations in the pre-contract stage. As such, it would be expected that the move towards larger contracts would increase DWP transaction costs such as pre-contract assessment and audit and compliance.

As the DWP moved towards a supply-chain model, some of these cost increases have been avoided as they have been passed on to the prime contractors. For the winning tender therefore, the transaction costs incurred during the process not only include an extended pre-contract period inclusive of bidding documents, negotiations with commissioning bodies, partners and competitors, including research and development of services to match the expectation of the tender, but also the audit and compliance of sub-contractors within their supply chains. Whilst some private sector organizations are familiar with these responsibilities and costs from other policy areas, such transaction costs are new to many organizations involved in employment support or the welfare to work market. In particular they are new to those organizations, such as Albase, who had previously been involved in the delivery of employment programmes which did not involve a contracting process.

There are a number of costs that providers must cover to be able to compete in the welfare to work market. Using research into Albase, three types of costs associated with resources expended by provider organizations can be identified; 1) market participation costs, 2) business acquisition costs, 3) traditional transaction costs. Each is discussed in turn.

An increase in the number of competitors in a quasi-market has an impact on the costs associated with generating the required information to win a contract. Market participation costs increase because each organization is required to expend more resources on gathering competitor information, matching competitor innovations, and marketing their own product or services to commissioning bodies and other institutions or actors associated with the welfare to work environment. A number of costs can be identified which are indirectly associated with acquiring contracts and can be attributed to the need for competing organizations to which meet the norms and expectations of the market. For example, Albase invested in "Central Business Support Services" such as HR, Finance, IT and Marketing functions to ensure that the organizations development reflected the requirements of the broader welfare to work market. There are also costs associated with keeping informed of others in the market and arranging meetings, attending conferences, joining official networks and member groups such as the Employment Related Services Association (ERSA). Some of these costs will not be recovered directly.

There are two main areas where Albase dedicated resources to market participation. First, it appeared that one of the biggest changes for the WG was the staffing implications involved with market participation costs. The organization sought to improve HR systems to, "ensure that Albase is an employer of choice,[14]" which included the creation of new policies such as a Conflict of interest policy, a Whistle Blowing Policy, and an Equal Opportunities policy, revised maternity and paternity leave arrangements and updating recruitment policies, to ensure "the continued good reputation of Albase, which is vital in terms of a sustained market position and growth[15]". A new pay policy and grading structure was introduced in 2008-2009 to develop the organizations ability to attract and maintain staff in the welfare to work market. The organization also expanded its core staff numbers and moved towards employing more staff on permanent contracts instead of temporary contracts as they had previously. For example, 92 employees were recruited permanent contracts in 2008. These efforts appeared to be the outcome of concerns that the organization required experienced and dedicated staff that otherwise may have been attracted to competitors if they did not improve employment policies.

Market participation costs also involve employee resources in terms of time and resources involved in generating and maintaining relationships with both partners and competitors and in gathering the required information to make competitive decisions. Alongside the increase in employees with duties and responsibilities dominated by the welfare to work market, one respondent felt that DWP contracts involved, "much employee time dedicated to keeping an eye on the environment[16]."

The second key area where Albase invested resources was their IT and business systems as there was a perceived need for IT investment to ensure that the organizations process comply with the expectation of the DWP and the ICT facilities offered by competitors. For example, the WG launched an ICT development in 2006/2007 to "streamline our systems and information flows between departments." They also secured $1.8m of free Microsoft software through a Microsoft Cybergrant Scheme, migrated to 'cloud computing', implemented a 'substantial and complex Information Security Plan' to fulfill DWP requirements and moved to the use of Customer Relationship Management (CRM) software to manage FND phase 1 with 15 subcontractors[17]. The rationale for this investment of resources was:

"In order to position Albase for future growth and deliver on the strategic financial and social objective set, detailed financial analysis has resulted in an up-front investment requirement over the next 3 years.[18]"

Whilst there are a number of costs associated with tendering and securing welfare to work contracts, market participation costs are often ignored. The case of Albase helps to display the resources required by TSOs to compete for welfare to work contracts.

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[14] 2007 Social Accounts
[15] 2006 Strategic Priorities
[16] Respondent 7
[17] 2009 activity annual performance report
[18] 2010 Income growth assumptions

The second set of costs associated with recent welfare to work contracts is business acquisition costs. In order to be able to deliver a welfare to work programme the provider must satisfy a number of DWP requirements during the tender process. The information required during the tender stage has grown with each new major welfare to work programme. In Albase information and input was required from a range of internal departments; finance, development, current contract managers, whilst also the involvement of the leadership team was required for the whole 12-18 month tendering period. Employees in the development department were required to have bid writing experience to understand the requirements of the tender and where possible demonstrate previous success. For Albase this has led to an increase in employees working in the department and a move towards hiring more core staff on permanent contracts which enabled the development and retention of staff with welfare to work experience.

Investment in the organization's financial planning resource is a key development in order for bidding organizations to acquire welfare to work contracts. This is because the need to display to the DWP advanced internal financial processes has become more important as the contract size has increased. Prior to the FND programme each provider was required to provide their accounts and prove that they were financially solvent. However, they were not required to go into any details and as such, one respondent described earlier financial requirements as simple "tick box" processes. The FND required a more "rigorous financial assessment[19]" as it involved providers supplying financial information including the current year forecast, future budgets, and annual accounts. The DWP undertook a financial assessment which involved benchmarking organizations against DWP pre-agreed standards designed to ensure provider viability. This allowed the DWP to provide contractors with a growth limit, a maximum amount that each contractor could apply for. For example, for the FND Albase was informed that they could at a maximum of £19million per annum (although post-contract these figures were not constrained). The DWP concentrated only on DWP contracts so the growth figure only referred to the organizations turnover growth in relation to DWP contracts so for Albase it excluded growth from sustainability, regeneration and other employability activities.

Finally, traditional transaction costs are involved for organizations seeking to participate in welfare to work contracting. The DWP are not the only organization to experience traditional transaction costs associated with audit and compliance. Once the bidding organization has been successful in winning a welfare to work contract the organization has to fulfill the contract requirements which involves the cost of contract management (including post-tender negotiations), service delivery (through arrangements with sub-contractors), finance, claims and compliance, reporting to DWP and JCP teams, internal audit and monitoring, personnel and payroll functions, staff employment and recruitment policies, health and safety of staff and clients. Contractors also have to design and implement management arrangements with subcontractors or partners, which in Albase's case, was often through the use of service level agreements involving quality performance standards, record keeping and reporting expectations and financial arrangements. The audit and compliance costs include the collection of information from service users, ensuring that all data collection processes comply with data standards and in Albase's case, an overhaul of their internal audit processes to mirror those of the DWP.

Respondents said that the attention to audit was, "*pretty small, but it started growing dramatically*" with the onset of larger welfare to work contracts. Whilst the organization sought to invest in

[19] Respondent 2

improving audit processes as required by the DWP, one respondent said that they felt that, "*government contracts are littered with bureaucracy*." For example, contractors were required to ensure that programme administration paper work was complete (such as New Deal time sheets and personal advisor documents), and that job seekers were provided with the correct information and certificates, all of which had to be regularly evidenced by advisors and administrators. However, for the principal (DWP) to maintain control of the behaviour of the agent (the delivery organization) contract audit and control over time will increase. The larger contracts will attract more audit bureaucracy in order for the DWP to be assured that the activities undertaken within the supply chain meet their expectations.

Due to the requirements set out by the DWP, Albase invested in the development of a centralized system for programme administration and financial claims to process the required paperwork for the DWP contracts in a manner acceptable by DWP audits. The importance of demonstrating audit capabilities to the DWP was a key requirement in tender processes and the organization emphasized the developments in audit processes.

Our centralized approach to programme management, administration, claims and reconciliation has resulted in exemplary Financial Appraisal and Monitoring audits over each of the last three years, with a financial claw-back of less than 0.1%[20].

The result was that the organization invested HR resources into developing an audit and compliance team that over time grew quickly from 3 to 14 people across the business, working on a range of DWP contracts. The audit team had responsibility for keeping up to date with regular changes introduced by the DWP who were, "*continually reorganizing themselves and changing their regions and contract managers*." They also invested in new document management system, which enabled the scanning, management, storage and distribution of paperwork to allow the organizations to forward and share information with local JCP Offices, "*expediting the delivery of critical information*". Internal reports directly mentioned the need to adhere to government formats, such as, "*this report is presented in a format that aligns better with the EFQM Business Excellence Framework*" and, "*substantial and complex Information Security Plan approved by DWP*." References to recognized industry standards such as the Scottish Quality Management Systems (SQMS), Membership of Quality Scotland and Investors in People, and demonstrating that internal staff are trained EFQM assessors also appears to be a necessary component of the tender process and all increase the transaction costs for the provider organization. Internal documents appeared to show that the organization had to spend time and resources adhering to DWP contracting expectations and changing internal processes to mirror the DWPs, which one respondent felt meant that the organization did not have the choice to design their own processes as the DWP requirements are most important. As respondents stated, *"actually, what you had to do was, internally, you had to build your internal structure to mirror that nature of those external contracts,*[21]*" and, "And if you want to get in the game with them, to run the contracts for them, you have got to do that [establish bureaucratic processes]"*[22]. In comparison to business acquisition and market participation costs these transaction costs are often covered in the service fee of the associated contract. Nevertheless,

[20] Anon tender doc 5
[21] Respondent 8
[22] Respondent 7

the organizational learning and resource required to meet the expectations of the DWP are an essential aspect of successfully securing and managing DWP contracts.

Albase's involvement in the welfare to work market reveals the financial costs associated with the acquisition of contracts and resources. Figure 2 below summarizes the three types of costs identified above. These costs act as 'capital barriers' to all providers but, as Oster (1995) points out, TSOs typically have more problems raising capital than for-profit organizations, both because they are precluded from raising equity and because their collateral assets are generally quite specific to the enterprise.

Market participation costs	*Business acquisition costs*	*Transaction costs*
Core staff	Bid writing team	Audit systems
Business investment	Bid writing process	Contract management
Partners and competitor knowledge	Financial capacity	Compliance reporting
Policy awareness and marketing	Leadership resource	Legal costs

Figure 2: Costs involved in the welfare to work market

So far we have seen that the increase in risk, the requirement for upfront funding for service delivery in payment-by-results models, and the three contract related costs above have the potential to limit the involvement of TSOs with historical legacies in other forms of funding, or which do not have access to funding to upgrade systems to match the market requirements. Below these points are expanded on and it is argued that the increase in such costs for competing providers highlights the complexity of issues which hinder TSO market participation.

First both market participation and business acquisition costs are expended without any guarantee that contracts will be secured and costs recovered from the service fee. As such those organizations without in-house resources may not be able to find the necessary cash to fund these activities. Similar to the payment-by-results difficulties, expenditure on these unsecured investments may increase the financial risks associated with welfare to work contracting. Furthermore, TSOs who are unable to raise the necessary capital simply cannot afford to spend money on areas which do not guarantee future funding. However, if TSOs do not involve themselves in these costs, it is unlikely that they will ever be able to access welfare to work funding. Whilst the DWP has reduced its transaction costs, involvement costs for providers have increased.

Second there are difficulties for TSOs who have an organizational structure focusing on providing services. The need to invest in market participation and business acquisition costs detracts time and finances from developing other business areas and investment in unique organization-led developments.

"I think that having Flexible New Deal just sucks in thinking time and energy from the management teams[23]".

[23] Respondent 6

Some respondents felt that Albase had been susceptible to activity drift as internal resources and profit from all programmes became directed towards developing the organizations towards the needs of the welfare to work market.

"All the energy gets pulled, the centre of the organization's income gets pulled to these big programmes[24]"

One issue for Albase was the implication of investing in aspects of the organization to ensure welfare to work competitiveness is maintained. The size of these costs and the amount of resources expended commits the organization to the welfare to work market. Moving to other policy delivery areas becomes more difficult and at each tendering stage the decision to leave the market becomes more difficult, despite the increase in financial risks associated with the payment-by-results model. This is because the organization's leaders have already invested heavily in the market and in their organization to ensure the organization has become market facing in terms of structure and staff responsibilities.

Conclusion

This paper has demonstrated that the number of TSOs involved in welfare to work contracting has in recent years declined. It argues that this is due to a number of market modifications based on recommendations from the Freud Report which increase risk for providers, and emphasize a payment-by-results model. These have created an unequal playing field for TSOs who have capital raising limitations. The paper has shown that the difficulties facing TSOs are due to; the increased risk, the requirement for upfront funding and the evaluation of organizations based on their turnover, and the increased costs of involvement identified as; market participation, business acquisition, and transaction costs. It has also been argued that the costs associated with welfare to work contracting now exclude a number of organizations from participating in the delivery of employment programme based on their financial acumen only, and those which remain are confronted by revised power hierarchies as they no longer partake in transactions with the state, but with private sector organizations. This causes an increase in transaction costs for TSOs and a difficulty in establishing partner relations as previous structures have (in the case of Albase) been directed towards the requirements of the DWP.

The paper concludes by questioning whether TSOs are being priced out of the delivery of welfare services, and whether the supply chain arrangement will create power relations which affect the service provision and behaviour of TSOS which remain part of a service design system. Are TSOs able to (re)enter the market without extremely large amounts of working capital and financial risk assurances? What impact will this have on the variety of organizations in the field and future innovation? Without the involvement of TSOs at this stage in the market, it is unlikely that they will generate enough resource to build their internal capacity and knowledge in the market to compete in the next round of tenders. Using the instrumental case study it appears that TSOs are indeed required to invest heavily in order to enter and remain competitive in welfare to work contracting, with the aim of securing a contract which may or may not (depending on performance) cover the costs expended, and ideally provide surpluses which can be invested in developing TSOs for future competitions. Without these resrouces it is unlikely that Albase could compete, and likely that the

[24] Respondent 1

Third Sector more broadly will continue to decline in the proportion of contracting success rates. Consequently, this raises questions regarding the competitiveness of the future welfare to work market, and the involvement of the third sector.

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NOTES

i For further information on ALMP see Bonoli, 2010

[ii] The UK government uses 'voluntary sector' and 'third sector' interchangeably in some of its policy documents and statements. This paper uses the term 'third sector' and incorporates organizations which are registered charities, non-profit making organizations, and social enterprises. For further discussions regarding the composition of the third sector see: http://www.tsrc.ac.uk/

[iii] Some specialist programmes have focussed on increasing employability more broadly such as Pathways to Work (see Hudson, et al. 2010)

[iv] The OFTS was replaced in May 2011 by the coalition government by the Office for Civil Society

[vi] The remaining two were awarded to a public sector education organization.