SOCIAL FINANCE

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AS WELL AS INCREASING THE DIVERSITY OF PUBLIC SERVICES, THERE IS AN OPPORTUNITY AND A NEED FOR MORE INNOVATION IN THE FINANCING OF PUBLIC SERVICE PROVIDERS… THERE HAS BEEN EARLY PROGRESS LOOKING AT INNOVATIVE FINANCE, SUCH AS SOCIAL IMPACT BONDS.

Open Public Services H.M.Government, July 2011

PURPOSE

There is a growing recognition that if long-standing social needs are to be better addressed in a difficult financial climate, it is critical to ensure that services are more focused on the social outcomes they seek to achieve and are given more flexibility in determining how to deliver these outcomes. Our experience is that many social sector organisations could excel at meeting these challenges. They often have an ethos of looking at the needs of individuals and communities in the round rather than focusing on delivering a very specific activity. Many have considerable experience of improving the outcomes of vulnerable groups and in providing early intervention and preventative programmes. But in the past they have been often held back from playing these roles by a lack of capital and a commissioning focus on delivering activity rather than outcomes.

Social Impact Bonds are a response to these opportunities and challenges. They enable social sector organisations to play a greater role in delivering public services through outcomes-based contracts by providing the risk finance and working capital required. Investors are rewarded by commissioner payments only if outcomes are achieved, transferring some risks away from commissioners.

The purpose of this paper is to explore the practical issues involved in taking forward such an approach from the perspective of public sector commissioners. Building on a Technical Guide to Social Impact Bonds, published in March 2011,[1] this paper provides further information on potential procurement approaches for those who have decided that a Social Impact Bond is an appropriate way to develop or improve a service.

We are grateful to PricewaterhouseCoopers LLP who undertook the development of this analysis for Social Finance by drawing on their considerable experience in supporting high quality commissioning and procurement across the public sector. We appreciate the contribution of a number of commissioning bodies and other interested parties who have provided their views and comments on this paper as well as the support of the Big Lottery Fund in the development of Social Impact Bonds. Given that the procurement of Social Impact Bonds is very much in its infancy, practice will inevitably develop over the coming years. We welcome comments and aim to update this paper on an occasional basis as further applications and approaches emerge.

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1 *A Technical Guide to Developing Social Impact Bonds*, Social Finance, 2011, available at www.socialfinance.org.uk

1 Introduction

Social Impact Bonds are a form of financing that aligns investor returns with social outcomes: investors only receive a return if the social outcome is achieved.

Since Social Finance launched the first Social Impact Bond in September 2010 to reduce re-offending among short sentenced prisoners leaving Peterborough Prison, the concept has attracted considerable interest. There is, however, a long way to go before they are commonly used.

Like any new approach, it will take a while for people to understand when and how to establish Social Impact Bonds. The purpose of this paper is to help commissioners consider how best to develop and procure Social Impact Bonds. The commissioners we have spoken to face a common set of issues. These include:

- How to design a Social Impact Bond that is attractive to social investors and delivers value for money to the taxpayer
- How to procure a Social Impact Bond when there may be few organisations able to bid
- How to develop a payment mechanism on the basis of outcomes to ensure that any improvement in outcomes is due to the Social Impact Bond funded provision rather than external factors

This paper seeks to address such high level issues by considering:

- The applicability of Social Impact Bonds – when are they likely to be appropriate?
- Potential approaches to procurement and contracting – what specific issues should be considered when commissioning Social Impact Bonds?

This paper does not aim to provide definitive procurement guidance. Every new Social Impact Bond will need to be treated on a case-by-case basis and is likely to require specific support from procurement teams. But we hope that it will help commissioners understand some of the approaches that could be most promising and stimulate discussion around the best way to develop procurement practice in this emerging field.

2 When are Social Impact Bonds relevant?

There is a growing consensus that the focus of commissioning should often shift from the delivery activity to the achievement of outcomes.

Commissioning for outcomes can encourage greater innovation in services and help to direct resources to preventative activities to address problems before they become entrenched. Social Impact Bonds – where social investors provide the upfront funding for services and are rewarded if outcomes are improved – were developed as a way of financing this move to outcomes-based commissioning. In particular, they enable organisations in the social sector without large reserves or access to finance to deliver outcomes-based contracts because investors bear the risk and provide working capital required for such an approach.[2]

The first Social Impact Bond was launched in September 2010. The Ministry of Justice entered into a contract with a partnership of investors to reduce re-offending among those leaving Peterborough Prison. On the back of this contract, the Social Impact Bond secured nearly £5 million of social investment to fund a number of service providers to support ex-prisoners by helping them to find a home and job, addressing family problems or tackling addiction. Payment will only be made back to investors if re-offending falls.

When should commissioners consider facilitating a Social Impact Bond?

In order to decide whether to stimulate the development of a Social Impact Bond, commissioners will need to decide that it is appropriate to fund a service on the basis of outcomes. Typically this will be because they want to encourage improved delivery of these outcomes and transfer the risk of delivery failure away from the public sector. Since payments are at risk, outcomes funding should offer providers incentives to develop better approaches, give greater attention to how the service is performing and invest in the skills and systems necessary to achieve improvement.

The distinctive element of enabling the creation of a Social Impact Bond, as opposed to establishing a standard outcomes-based contract, is that the contract is explicitly designed to bring in social investors. This new breed of investor is motivated by a social as well as financial return. They may be willing to take on the risks of service delivery if greater social impacts can be achieved. Often such social investors are grant-making organisations with experience of funding projects that tackle the social problem being addressed. They are keen to support more sustainable methods of funding frontline services. They may also be able to bring expertise to the project and, because they share similar values and objectives, can engage well with the social sector organisations delivering the service. Over time we expect individuals and institutional investors to engage in social investment.

Ensuring that social investors are involved in backing the services delivering an outcomes-based contract is important when most potential providers are not willing or able to bear the risk and fund the working capital required to deliver the service before outcomes payments are made. Typically this will be when social sector organisations, without large reserves or the ability to raise finance through traditional commercial routes, are potentially important providers. In particular, commissioners should consider a Social Impact Bond mechanism when they are:

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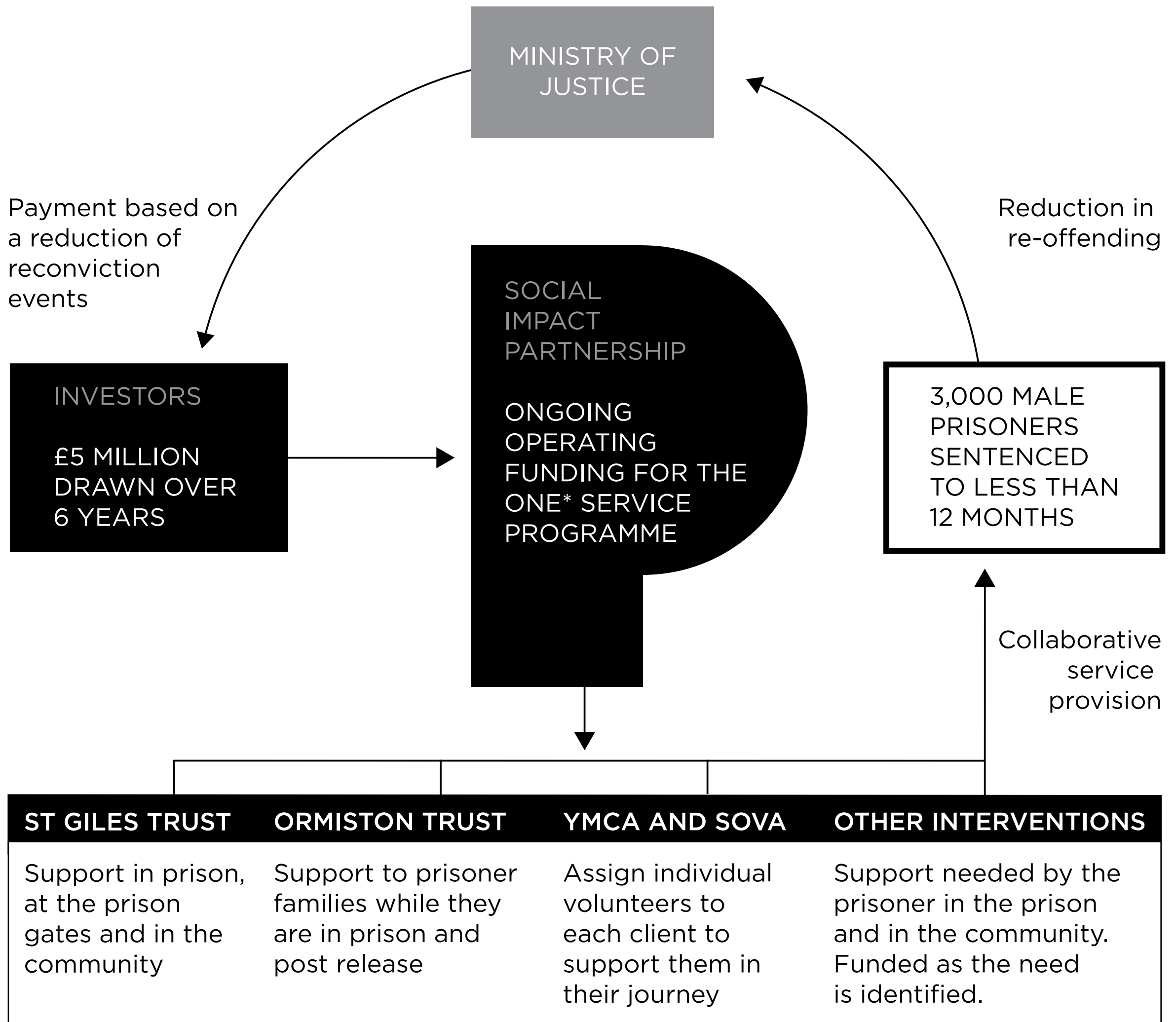
2 Despite their description as a 'Bond' the return to investors is not fixed. Payments are dependent on the achievement of a social outcome, usually based on a contract with public sector commissioners.

Figure 1: Peterborough Social Impact Bond



- **Seeking to overcome a complex social issue** – which are inherently more risky and might be best addressed by small or medium sized social sector organisations. In these cases, fewer established organisations will be willing or able to develop such services from their own reserves. They are likely to need to bring in external investors to share the risk. Addressing a complex social need may also require a number of service delivery organisations to come together. Investors may be well placed to draw together such arrangements through establishing a new organisation to co-ordinate provision or a consortium of providers.
- **Looking to introduce a new service to prevent future problems arising**, where a proportion of the outcomes payment is dependent on reducing the need for spending on other services in the medium term. Again, such approaches are risky. If payment is dependent on future savings, providers may need to wait a number of years before payment. However, establishing a new, more preventative service may be particularly appealing to social investors.

Examples of areas where Social Impact Bonds are likely to be relevant include:

- Reducing re-offending;
- Supporting families and young people with multiple problems to break out of long term cycles of deprivation and dependency;
- Helping people tackle drug and alcohol addiction;
- Addressing homelessness;
- Preventing young people from becoming workless; and
- Managing chronic health problems such as diabetes and asthma.

In all of these areas, commissioners are already starting to explore Social Impact Bonds. We see scope for a number of such contracts to develop over the next few years.

When are Social Impact Bonds not needed?

There will be many services where it is still more appropriate to fund on the basis of activity rather than outcomes. In particular, in some services there may be few opportunities or benefits associated with transferring risk to an independent provider or investors. For example, if the way in which the service is provided is heavily prescribed by statutory obligations, such as policing, there may be little scope for innovation by paying on the basis of outcomes. It may also be difficult to transfer risk because it is not possible to write an effective outcomes-based contract, for instance if it is hard to ensure that any change in outcomes is due to the impact of the new programme rather than external factors. Finally, there will be instances where it is almost certain that the desired results will be achieved by paying for the activity. To delay payment until outcomes are verified would simply incur costs associated with raising working capital.

If commissioners are looking to shift contracting to the basis of outcomes for the primary purpose of encouraging better performance within an existing approach, it is probably not necessary to explicitly consider the role of investors. The existing providers should be able to cover service costs through their own reserves. Risk transfer will typically be lower and service providers will feel more comfortable taking these risks themselves. In these instances, a Social Impact Bond is not required. For example, if a commissioner of a back-office service is looking to introduce an element of payment by outcomes, there are likely to be a number of large, well-capitalised commercial providers who would be interested in providing the service and will be able to cover the risk from their own reserves. It will not be necessary to consider the needs of attracting investors, particularly social investors, in procuring the service.

In practice, there will be a spectrum of outcomes-based commissioning approaches where investors bear more or less of the risks involved. There is no absolute point at which a Social Impact Bond is needed and other types of outcomes-based contracts are inappropriate. The issue for commissioners is the extent to which it is important to stimulate better delivery by paying on the basis of outcomes and the likelihood that external investors will be required to share the risk of achieving these outcomes.

3 Key issues when commissioning Social Impact Bonds

Like all good commissioning, understanding the nature of the needs to be met by a service, the contribution of existing services to addressing these needs and gaps or problems in current provision are essential first steps in determining the applicability of any outcomes-based contract approach. Assessing whether Social Impact Bonds are a feasible and appropriate mechanism for addressing unmet needs should be a second step for commissioners. Social Finance has published a Technical Guide to Social Impact Bonds[3] that covers these issues.

Similarly, many of the other core principles of good procurement will apply to commissioning Social Impact Bonds, such as understanding what represents good value for money, testing the market, assessing the deliverability of service proposals and drawing up an effective contract. Appendix A sets out some of the core questions.

Social Impact Bonds do, however, raise new opportunities and challenges for commissioners. The core task for commissioners is to recognise that the very nature of service areas where Social Impact Bonds may be applicable – meeting complex social needs which there are few well capitalised existing providers – mean that traditional approaches to procurement may be ineffective. Commissioners of Social Impact Bonds, at least in the short term, are unlikely to be able to simply put out a tender and find a number of bidders. They will need to think about how to engage with potential social investors and more generally how to build the market of Social Impact Bonds providers as they go along.

In this context, commissioners have raised with us a number of particular challenges:

- Structuring a procurement process and contract in a way that is attractive to social investors, whose interests and constraints may be unfamiliar;
- Identifying ways of judging a fair “price” for outcomes in new markets and safeguarding against the two extremes of “supernormal profits” for investors or providers (if the price is too high) and service failures (if the price is too low);
- Developing outcomes-based contracts in relation to complex social issues, particularly where there may be a range of outcomes sought (a more significant challenge than payment by results contracts for relatively established services); and
- Integrating the new Social Impact Bond funded service with existing, in some cases statutory, provision.

In the rest of this paper we outline the potential options or approaches to resolving such issues:

- Developing the right Social Impact Bond model;
- Managing statutory obligations within Social Impact Bonds;
- Understanding alternative delivery structures for a Social Impact Bond;
- Designing the procurement process;
- Creating the right delivery incentives; and
- Budgeting for Social Impact Bonds.

3 *A Technical Guide to Developing Social Impact Bonds*, Social Finance, 2011, available at www.socialfinance.org.uk

4 Developing the right Social Impact Bond model

The impetus for considering a Social Impact Bond may come internally from an overall assessment of need in an area or from a review of the service. Commissioners may also find others suggesting that a Social Impact Bond should be established, such as a social sector organisation with an existing interest in addressing a social problem. Commissioners may be offered opportunities to take part in national pilots for outcomes-based commissioning contracts or be approached by social investment intermediaries or consultancies offering to develop Social Impact Bonds. Commissioners may, therefore, be asked from various sources to come to a conclusion over whether they want to establish a Social Impact Bond.

In our experience, it is worth starting the process of considering a Social Impact Bond with an initial pre-feasibility assessment. It is not going be in the interests of commissioners, investors or providers if work to develop a Social Impact Bond starts before the fundamental preconditions for success are established.

We suggest that a pre-feasibility assessment evaluates whether:

- The commissioner can broadly define the overall outcomes being sought and for whom;
- There is a need for a new service to improve these outcomes and how it might fit alongside existing provision;
- The commissioner can envisage being able to measure these outcomes;
- There are identified cashable savings that could be realised in the medium term if outcomes were improved and that those parts of the public sector that could make the savings are willing to use these savings to make outcome payments; and
- The commissioner(s) would, in principle, be able to sign up to a medium-term contract (three to seven years) in order to attract investors to develop a new service.

Some of the most exciting potential Social Impact Bonds will require commissioners to come together from different services to jointly commission improvements in a number of interrelated outcomes. For example, health, employment and reducing re-offending outcomes may all be improved by helping people recover from drug or alcohol addiction. Building such partnerships between commissioners early in the process might be time-consuming but essential to the eventual success of the model.

If the pre-feasibility conditions are in place, further work will be required to test whether a model is feasible. We consider that there are two promising approaches to assessing such feasibility. One approach is to undertake a full feasibility study. The purpose of such a study is to consider, in detail, whether it is necessary and possible to establish a Social Impact Bond. This is likely to involve:

- Assessing whether there are promising interventions that could deliver the desired outcome if investment were forthcoming;
- Analysing public sector costs and identifying where savings might be generated by early interventions;
- Developing key criteria for an outcomes-based contract, such as attribution mechanisms;

- Confirming that social investors are required because many or all potentially good providers would be unwilling or unable to enter into the contract at their own risk;
- Assessing the level of risk transfer to investors, gauging interest from investors and potential rates of return that they may require.

Typically such studies take three to six months. The great benefit of this approach is that by the end of the study, the commissioner should be in a position to set out the key terms of a Social Impact Bond contract, should one be appropriate. This will make subsequent Social Impact Bond design and procurement much more straightforward.

An alternative approach is to seek to learn more from potential providers about how they envisage a Social Impact Bond improving outcomes and making savings. This may be helpful when, for example, the commissioner is aware that a number of providers have already worked up proposals for Social Impact Bonds and wish to compare which might be the most favourable. It may reduce the need to undertake feasibility assessments of whether there are promising interventions, providers and investors, because these become clear during the market testing. It can be a good way to stimulate innovation. Seeking propositions from providers can also help establish the price per 'outcome' that providers and investors are prepared to offer.

This is the strategy that the Department of Work and Pensions' Innovation Fund is taking to assess the potential for using social investment to fund improved outcomes for young people who are Not in Education, Employment or Training (NEETs). The Innovation Fund invited applications from partnerships of providers and social investors, with the first stage simply asking for initial proposals setting out features such as the target population and rationale for the proposed service. The most promising partnerships were then invited to submit full proposals.

5 Managing statutory obligations within Social Impact Bonds

One of the issues that commissioners have raised most consistently is how to manage statutory obligations when developing a Social Impact Bond. This question is common to all outcomes-based contracts, not just Social Impact Bonds. However, because Social Impact Bonds are often seeking to address complex social needs that involve vulnerable groups, it can be particularly important.

The purpose of an outcomes-based contract is to allow providers and investors the flexibility to try new approaches to achieving outcomes. Commissioners should therefore not be seeking to specify how a service is delivered. Yet, the State may also have specific duties to provide particular services in certain ways, rather than simply achieve broad outcomes. Local Authorities, for example, have duties to protect children at risk. Probation services have obligations to deliver the level of supervision required under a sentence. Outcomes-based contracts to improve the wellbeing of children or reduce re-offending cannot substitute these requirements.

Our recommendation is that such statutory obligations are not generally managed through a pure outcomes-based contract. Commissioners will usually require more control over how services are delivered and be able to transfer less risk. Social investors are unlikely to wish to fund statutory provision.

Where statutory and non-statutory obligations are closely integrated, we suggest that commissioners:

- Establish an outcomes-based contract for a new service to 'wrap around' existing statutory provision (which would continue to be funded through traditional means). For example, alongside any new Social Impact Bond services to support vulnerable young people or families, Local Authorities would continue to employ social workers to make an independent judgement over child safety; or
- Develop a hybrid outcome- and activity-based payments approach. For example, contracts around the delivery of probation services in the future could include a combination of payment by activity to discharge statutory obligations and payment by outcomes to draw in greater investment to reduce re-offending; and
- Ensure that contracts for the outcomes-focused service, or elements of the service, include incentives to complement and enhance the delivery of statutory duties.

6 Understanding alternative delivery structures for a Social Impact Bond

Once the feasibility study or initial call for proposals has confirmed that a Social Impact Bond is appropriate, we suggest that commissioners assess the likely structure of the relationships between commissioners, investors and providers. While it may be possible and desirable to design procurement approaches that are open to a variety of delivery structures (including direct providers of services who have sufficient balance sheets to finance outcomes-based contracts themselves) it is helpful for commissioners to bear in mind the different types of delivery models that may be most viable and how the procurement process can be attractive for such structures.

Model A	Merits/considerations
An investor Social Impact Bond Delivery Agency that will source the investment capital required, act as the co-ordinator of the contract and sub-contract the delivery of the specific services required to achieve the outcome.[4]	This is the model that is used for the Peterborough Social Impact Bond to reduce re-offending. In this instance, a Social Impact Bond Delivery Agency, the One* Service, was established to manage the contract and co-ordination of delivery on behalf of investors. It sub-contracts the support for ex-offenders to four social sector organisations. One of the advantages of this model is that it establishes an organisation that is focused on improving collaboration and performance management. It can also provide the scope to bring in new service providers over time, which can be attractive to investors and commissioners. A new structure will, however, involve set up and running costs.
	APPLICABILITY Where it is likely that a number of services providers will be required to be brought together to achieve an outcome, such as to provide a range of support to families suffering from multiple problems; Where it may be important to enable investors to change service providers over the course of the contract, if for instance they want to raise the performance of existing service providers.
	IMPLICATIONS FOR PROCUREMENT DESIGN The typical minimum contract size for establishing a separate investor-owned entity is probably around £5 million, and would ideally be over £10 million in order to cover set up and running costs; Sufficient time will need to be allowed in the procurement process for investors to establish new Social Impact Bond Delivery Agencies to bid to deliver the contract and to finalise arrangements with sub-contractors once an investor owned Delivery Agency is the preferred provider – each process could require a number of months; Commissioners will need to test the ability of bidders to deliver the outcome whilst recognising that new Social Impact Bond Delivery Agencies will not have been able to finalise their sub-contractors prior to being awarded the contract. For example, the procurement process might look to test the ability of potential Delivery Agencies to effectively procure and manage sub-contractors and/or whether they have tested the market for suitable sub-contractors.

4 Such organisations, established to deliver a particular service, are often described as Special Purpose Vehicles.

Model B	Merits/considerations
A partnership of investor(s) and providers establish a Social Impact Bond delivery agency.	Some social sector organisations are seeking to lead the development of Social Impact Bonds to address problems they are familiar with. In these instances, the social sector organisation is looking for investors. Investors will still need to have a central role because their money is at risk, but the key provider will be a partner in the Social Impact Bond Delivery Agency rather than a sub-contractor.
	APPLICABILITY When the service is relatively focused and therefore a single lead provider may well be able to deliver it, in partnership with investors, rather than investors needing to bring together a range of disparate providers; When the commissioners wish to be certain which organisation will be the lead provider rather than simply commissioning an investor-led body; When existing services providers have a sufficient track record that investors will feel confident entering into partnership with them.
	IMPLICATIONS FOR PROCUREMENT DESIGN Commissioners may benefit from seeking to facilitate partnerships, for example by holding events at which interested investors and commissioners can come together; Commissioners will also need to recognise that investors will generally only provide an 'in principle' commitment to work with a particular provider at the initial bidding stage. They should allow time for commitments to be finalised through a more detailed process of due diligence during the procurement process; Contracts will probably need to enable the partnership to change providers or even to terminate the service in the event that poor delivery is leading to significant loses for investors.

Model C	Merits/considerations
Joint Ventures between Investors and Public Sector	It may be possible to deliver Social Impact Bonds through Joint Ventures between investors and existing public sector providers of services. We have been examining the scope for such approaches in health and justice services, although we have not yet finalised potential models. For example, in developing better health services to manage long term conditions such as diabetes in the community, it might be beneficial to involve existing primary and community care NHS services as partners alongside investors and social sector providers.
	APPLICABILITY Joint Ventures are appropriate when social investors and the public sector would bring complementary resources to a partnership. For example, an existing public service team might contribute expertise, experience and an established service delivery infrastructure. Investors could bring risk finance, management and commercial expertise.
	IMPLICATIONS FOR PROCUREMENT DESIGN Procuring Joint Ventures requires careful consideration of issues such as the structure and governance of the future service. It is likely to require considerable dialogue and negotiation with the preferred provider(s). HM Treasury has issued specific guidance on the procurement of Joint Ventures that provides an overview of approaches;[5] In establishing a Social Impact Bond Delivery Agency as a Joint Venture, it will be important that investors have the majority control over the new entity if they are taking the majority of the risk. Otherwise, they will fear that they will not be able to secure their investment. If the public sector maintains the majority of control, there are also likely to be significant implications in how investment and expenditure are accounted for which could be unattractive for commissioners (see Section 11 and Appendix C)

5 *Joint Ventures: a guidance note for public sector bodies forming Joint Ventures with the private sector,* HMT, 2010.

7 Designing the procurement process

Unlike more traditional service contracts, the lack of sufficiently capitalised providers and the new nature of service provision, often inherent in the decision to develop a Social Impact Bond, present challenges for commissioners.

Various factors will generally influence which procurement approach is best. In particular:

- The nature of the market of potential social investors and service providers; and
- The requirements that will need to be met in relation to the European Union and other regulations.

In short, commissioners will want to select a process that, on the one hand, is open, fair and drives value for money and, on the other hand, is not too onerous in time and resources to present significant barriers to providers bidding for or engaging in the procurement.

We consider that it is critical for commissioners to recognise at the outset that Social Impact Bonds are being established in a very new and potentially fragile market. Poorly designed, changeable, resource intensive processes that require large and specialised bid teams will put off investors from becoming involved in financing innovative outcomes-based contracts. Social investors are not looking for large financial returns. They will not be prepared to provide significant resources to fund complex bids with the expectation that they can generate significant profits later on. Nor will most social sector providers have the reserves to fund such bids themselves. If such hurdles are put in the way, particularly for the first Social Impact Bond in an area, rather than opening up public service provision to a much wider variety of innovative service providers and investors who wish to make a social contribution, outcomes-based contracts will simply become the preserve of experienced, well-capitalised providers.

The extent to which there are likely to be providers and funders available

Through engaging with potential providers and investors prior to procurement, commissioners should have a broad understanding of the market prior to commencing a procurement process.

The Peterborough Social Impact Bond to reduce re-offending was not procured through a competitive process. It was undertaken as a 'proof-of-concept' pilot, with value for money assessed through internal analysis and signed-off by the Treasury.

If there is only one provider, commissioners are not obliged to undertake a competitive process. As markets develop, we expect there will be other contracts procured in a similar way to Peterborough. However, we envisage that a number of potential providers are likely to emerge after each first Social Impact Bond is established in a new field.

In the instance of finding only one provider, commissioners will also need to develop other ways to ensure value for money. For example, in the Peterborough Social Impact Bond, maximum returns to investors are capped. Similarly, it will be important for commissioners to ensure that any contracts build the market and encourage new entrants. For example, information about the project, such as evaluation reports, should be placed in the public domain, so that others can learn from the process. Again, the Peterborough pilot is subject to a detailed public external evaluation process.

Assessing Social Impact Bond proposals

The specific criteria for outcomes-based contracts, which enable the establishment of a Social Impact Bond, will clearly vary according the objectives of commissioners in each circumstance. We consider that they will generally benefit from including the following five criteria:

- **Ability to meet outcomes.** Commissioners should avoid being prescriptive about how outcomes are delivered. Encouraging innovation may also be an explicit objective. However, it will still be important to test the robustness of the providers' plans for delivering the outcome, such as the evidence base and experience they are drawing upon and the quality control and management systems they will put in place.
- **Ability to source finance and providers.**[6] Given that raising finance will be difficult in new 'Social Impact Bond' service areas, it may not be possible for finance to be fully secure prior to a preferred provider (or providers) being chosen. Social investors, such as Charitable Trusts and Foundations, will want to see the final details of the proposed contract before committing investment. However, it will be important to test the ability of the social investment intermediary or consortium proposing to deliver the service at an early stage. This might include asking how they have tested investor interest and seeking 'in principle' commitments.
- **Price per outcome or share of saving returned to the commissioner.** Price will clearly be important and commissioners should have established a threshold price per outcome that is necessary for the Social Impact Bond to prove value for money. However, below the threshold, it may well be useful to put more emphasis on quality rather than price. We are aware, for example, of some providers of payment-by-results contracts who would consider just 'having a go' at a low price and walking away from the contract if insufficient outcomes are achieved to return a profit. Choosing a higher quality provider, at a price that still delivered sufficient savings, might prove greater value for money in the long term.
- **Ability to integrate with other services and support wider objectives of the commissioner.** Given that links between services is often essential for improving social outcomes, testing this specific element of the proposal may have merit. We consider that bidders should often be asked about how they will contribute to wider strategies, in order to test how they will avoid the risk of meeting their own objectives at the expense of undermining other objectives. Assessing the wider social, economic and environmental impacts of the proposal may be appropriate under this criterion.
- **Strategy for sharing learning and innovation**. Given that procuring Social Impact Bonds are new, recognising those proposals that share learning and help build the market will often be beneficial.

6 We assume that commissioners will usually want to procure outcomes-based contracts in a way that allows financing by direct provider organisations with sufficient reserves as well through a Social Impact Bond mechanism.

8 Complying with procurement rules

Those who have engaged with procurement in the past will be aware that the degree of regulation covering the procurement process will depend on the type of service and the size of the contract. The extent to which various EU and corresponding UK rules and regulations apply to services being commissioned under Social Impact Bonds will rest on a number of factors and in-house or external legal advice should be sought on a case-by-case basis. In this section, we seek to provide an overview of some of the most relevant issues.

Service contracts are divided into two categories under EU regulations (the 'Procurement Directives'):

- Services for which there is a particular interest in ensuring a fully competitive market across the European Union, such as consultancy services or delivering infrastructure projects. These are classified as 'Part A' services. Procurement of these services requires adherence to EU regulations, following one of four clearly specified procurement routes: an Open Procedure; a Restricted Procedure; Competitive Dialogue or a Negotiated Procedure (set out in Appendix B). The exception to this requirement is if contracts fall under a certain threshold, currently around £156,000 for service contracts.
- Services for which there is traditionally not a fully competitive market across the European Union, including education and vocational services, health and social services, and recreational and cultural services. These are called Part B services. These services need to follow a number of principles relating to fairness, transparency and open competition,[7] but are not required to comply with most specific EU regulations.[8]

More information on which services fall under Parts A or B and procurement regulation are set out in Appendix B. All procurement processes, whether or not the EU regulations apply, need to follow the UK Competition Policy and Treasury Guidance on achieving value for money.

We anticipate that the majority of Social Impact Bond services will be Part B services. Commissioners will need to follow principles such as non-discrimination, equal treatment and transparency, but will have greater freedom to determine how to specifically manage the procurement process. For example, they can set the timescales for the procurement and how to advertise and engage with potential providers. Public bodies procuring Part B services are also not usually liable to fines and other penalties if challenged over the implementation of the procurement process in the way that they are for fully competitive Part A services.

Commissioners should note that:

- While working capital funding for the service may be a component part of the 'service' being commissioned, financial transactions alone are not bound by the European regulations. This may be the case if the commissioner is raising investment to establish a Joint Venture, although the subsequent provision of the service back to the commissioner from this partnership may well require a process of competition governed by regulations; and
- Where the commissioning body requires advisory support, such as feasibility study, this is likely to be a Part A service, although if the proposed contract is below the £156,000 threshold it may only need to adhere to the principles of fair competition.

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7 These principles are set out in the EU Treaty rather than the Procurement Directives.

8 The main regulations that do apply relate to technical specifications and publishing a post award notification.

Procurement Routes

Assuming that the Social Impact Bond is delivering services that fall within Part B service, such as education, training, health or social care, we consider that there are number of promising procurement approaches which commissioners could explore:

- A single stage procurement in which bidders are assessed against a clear set of criteria to select a preferred provider;[9]
- A two stage procurement involving expressions of interest and subsequent selection of a short list of providers for more detailed dialogue;
- Engagement with a third party (in the form of a Joint Venture, partner or concessioner) to deliver some or all of the services required for the implementation of an outcomes-based service.

The tables overleaf illustrate the circumstances where such routes may be applicable and examples of where they are being currently implemented.

It may be valuable for interested commissioners to come together to establish a framework for procuring outcomes-based services. A framework is an agreement with providers that sets out terms and conditions under which specific purchases (call-offs) can be made throughout the term of the agreement. Framework agreements can be awarded to a single provider or with several providers.

Once a framework agreement is in place, contracts may be awarded without the need to re-advertise and reapply the selection and award criteria. However, where a framework is awarded to more than one provider, the contracting authority must ensure that it does not discriminate between the providers. The framework agreement should therefore carefully set out the terms on which a call-off can be made, for example, it might stipulate that a call-off will go to the provider with the most economically advantageous offer. Alternatively, the contracting authority may choose to run a mini-competition with all of the providers within the framework that are capable of meeting the particular call-off requirement.

Frameworks could be a useful way to develop Social Impact Bonds. The Ministry of Justice is planning a framework agreement to develop further payments-by-results pilots to reduce re-offending. Once providers are on a framework, they can be used to run processes with shorter procurement periods, lower bidder costs and standard terms and conditions. They may be appropriate when, for example:

- A number of Local Authorities wish to commission similar Social Impact Bonds, say to support elderly people with similar needs; or
- A national commissioner wishes to pilot an approach in a number of geographical areas spread over time.

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9 It will be important for commissioners to consider whether they will achieve greater value for money by undertaking detailed negotiations with one preferred provider or a number of providers. Our sense, given the immaturity of the market, is that negotiating with a number of providers could be overly burdensome for new social investors providing the funding to bid for Social Impact Bond contracts and risk undermining the emerging market. However, for very large contracts, and as the market matures, negotiating with a number of providers may be helpful. Commissioners may wish to consider covering some of their bid costs. Assuming the commissioner selects a single preferred provider with which to undertaken final negotiations, they will need to ensure that value for money can still be maintained, ultimately by retaining the ability to cease the process if it transpires that the proposed approach is not going to meet the needs of the population or represent good value for money.

Approach One: A Single Stage process to identify a preferred provider

Applicability

- When a feasibility study has been undertaken to enable the commissioner to develop a clear set of criteria for the tender and provide potential delivery organisations with up-front information on the defined target population, outcomes, attribution mechanism and links to existing services.
- If the feasibility work and market engagement indicate that there are a limited number of potential providers who already have good relationships with investors and are therefore able to submit a bid without significant additional work.

Potential steps in the approach

- Pre-procurement engagement with potential Social Impact Bond providers (investors and service providers) and advanced notice of a likely forthcoming contract.
- Very clear criteria set out as part of the procurement process, including any key price and quality thresholds.
- Background information published alongside the tender on the basis of the feasibility work, such as levels of need, and key elements of the contract, such as a mechanism for attributing impact.
- At least ten weeks for bids to be received, and potentially longer if investment will be difficult to attract or if the pre-tender advanced notice period was short. Given the nascent nature of the social investment market, getting 'in principle' agreement from investors to back a Social Impact Bond proposal can take a long time.
- Bids submitted and interviews held.
- The potential for commissioners to ask for clarification and engage in limited dialogue with bidders.
- The selection of a preferred provider.
- A period of final negotiations on issues such as ways of working and detailed contract terms. Investment will also need to be finalised in this period. We expect that it would typically take three months, at least in new service fields.

Example

This approach might be appropriate for a Local Authority looking to introduce a Social Impact Bond to fund better foster care, with payments made on the basis of improved well-being for children and young people and reductions in the need for expensive residential care.

Many elements of the approach could be defined in advance, such as the group of young people to be supported, the referral pathways, threshold prices for outcomes and attribution mechanisms, which would allow bids to be compared relatively easily. There are likely to be a small number of potential bidders if the financing requirement is significant, but sufficient numbers to hold a competitive process without extensive market building.

Approach Two: A Two Stage Process

Applicability

- When the appropriateness of a Social Impact Bond is confirmed, and a broad understanding reached around savings and outcomes, but not necessarily a full feasibility study undertaken.
- When commissioners are open to a range of possible Social Impact Bond models.
- When potentially selecting more than one successful provider, such as for a national programme of pilots.
- When the market is immature and/or when investors and providers need a high likelihood of being selected before they finalise their partnership.
- When there is sufficient in-house expertise or contracted-in advisors to select and negotiate with short-listed providers.

Potential steps in the approach

- Many of the elements will be similar to the single stage process outlined on the previous page. However, rather than a single bid, the core procurement will have a first stage 'Expression of Interest', which is likely to involve testing criteria such as:
  - Nature of proposal e.g. target population groups, reason for choosing intervention approach and proposed outcomes;
  - Ability to provide the service;
  - Ability to raise working and risk capital to support service delivery prior to future payments, such as through track record or 'in principle' support from investors; and,
  - Some elements of traditional Pre-Qualification Criteria (e.g. legal and commercial arrangements of the bidder). However, it may be possible to reduce the need for some criteria because in requiring an investor to support a proposal, it should ensure that their due diligence process screens out unsuitable providers.
- The second stage will require providers to respond to more detailed criteria, which may have been finalised following the first stage.
- In most cases, a period of dialogue with one or more providers will be required to finalise contractual terms.

Example

The DWP Innovation Fund to prevent young people becoming NEET is following a two-stage approach. The DWP were open to a wide variety of models. In the first round, core elements of the proposed approach were required. In the second, far more detail was required on aspects of the bid such as referral routes, links with other local services and outcomes prices.

Approach Three: Joint Ventures

Applicability

- Where the on-going engagement of the public sector will be very important. For example when the Social Impact Bond funded service needs to be partly integrated with existing services;
- Where successful services are already in place that can be built upon with additional investment rather than substituted by a new Social Impact Bond.

Potential steps in the approach

- It is likely that the commissioner will wish to find a Joint Venture partner and procure the service at the same time.
- It may be that the process should follow one of the standard EU procurement routes given the service is being procured. There are also various approaches for procuring partnerships that have been developed for Joint Ventures.
- We therefore consider that it is best for the commissioner to consult the HM Treasury Guidance on Joint Ventures and potentially seek expert advice.

Example

Long term health condition management. There is considerable scope for Social Impact Bonds to support new approaches to better managing long term health conditions, such as diabetes or asthma. Any additional services funded by the Social Impact Bond, such as supporting greater self-care by patients, would need to be closely integrated with other services, such as the local GPs and/or local hospital Foundation Trusts. A Joint Venture, with a delivery organisation governed by both investors and existing services, may align incentives and promote integration.

Other mechanisms that would be helpful in facilitating market development include:

- Collaboration between commissioning bodies to jointly procure a service. Many of the most promising preventative programmes achieve a range of outcomes. For example, measures to better support families facing multiple problems are likely to lead to improved family stability, lower offending and anti-social behaviour, greater employment, better school attendance and other outcomes which reduce Local Authority care costs, costs to the youth justice system, welfare and health costs. In these circumstances, Social Impact Bonds are more likely to be viable when commissioners come together. It would be helpful if local partnerships and Community Budget programmes jointly commissioned Social Impact Bonds, and central government funds were designed to support co-payments.

- Commissioning a number of Social Impact Bonds simultaneously or setting out a 'pipeline' of Social Impact Bonds so that the market can prepare to create the necessary Social Impact Bond 'infrastructure'. For example, the costs of raising capital are likely to fall if social investment intermediaries are able to raise funds for a number of similar schemes at the same time. If a pipeline of outcomes-based contracts is established, social investment intermediaries may also establish specific Outcome Finance Funds, which could again provide capital at a lower cost than through individual finance raising. More generally, small Social Impact Bonds may be uneconomic to structure. If the population group with specific needs is small in a particular area, commissioners should consider collaborating.

9 Creating the right delivery incentives

Outcomes-based contracts should provide strong incentives for delivery. Investors, whose money is at risk, should encourage better performance management and the deployment of resources to the most effective services.

Commissioners do, however, still need to consider how to engage with the Social Impact Bond Delivery Agency to ensure it meets their objectives.

Attribution

Designing a good system to attribute the impact of the Social Impact Bond will be essential so that the commissioner can be satisfied that "but for" the provider, the changes in outcomes would not have been achieved. Although it may not be possible to be absolutely certain of what would have happened in the absence of the provider or the Social Impact Bond funded interventions, attribution can usually be measured through:

- Control groups i.e. analysing the outcomes and effects on the public exchequer of the activities of similar groups or individuals that are not in receipt of provider services; or
- Intermediate (benchmark) data i.e. assessing the outcomes either against recognised norms or target outcomes (e.g. reductions in the average incidence of children being taken into care in similar areas).

It will be particularly important to think through the interaction of the new service with other programmes that may be serving the same population group.

Rewarding providers to work with the whole target population

In many situations, within a given population, certain types of social impact may be achieved more cheaply than others. For example, without a well thought through contract, a provider of services to reduce re-offending may initially target the least prolific offenders for whom outcomes are achieved at the lowest cost and only later move on to more expensive interventions/harder to influence sub-groups. Opting for a Social Impact Bond from a provider who offers the lowest price may not be the best value for money if it fails to incentivise an efficient level of investment. The payment mechanism may also need to be calibrated to give different incentives as performance tiers are reached to ensure efficient investments are made.

It will be important to think through, in advance, any perverse incentives that may be created through payment structures. For example, making payment entirely dependent on one 'pass or fail' event can unduly focus attention on the sub-group of the population closest to passing or failing the criteria and ignoring others. It is likely to be better, for example, to design a programme with financial incentives to help ensure young people do not need to come into Local Authority care by measuring reductions in the total number of days in care across a cohort of young people rather than simply whether they entered care or not. In this way, providers will be rewarded if they help families and young people even when it may be inevitable that the young person has to come into care for a short period of time. Getting incentives right at the end of contracts is particularly important, to ensure that providers effectively hand over to a new provider if necessary and continue to support those receiving the service during any period of transition.

Payment mix

Commissioners should also consider whether they make 100% of payments contingent on delivering outcomes/savings.

If commissioners are only able to afford the new preventative service if savings in acute services are realised, all or most payments may need to be to be based on outcomes which are closely linked to cashable savings.

However, capital will cost more the greater the amount, the longer it is required and the riskier the payment. So it is important to assess whether 100% outcome payments are necessary or if payment could or should be made for activity. It is also important to carefully think through the timing of performance payments. For example, where social investments are made in a health prevention intervention in Years 0–5 and social impacts are achieved in Years 5–25, it may make sense to make performance payments from 100% of forecast savings to be realised in years 5–10 in order to minimise the cost of funds charged by the social investor. The commissioner will only make net savings after ten years. In this example, the commissioner has made payments from savings but has minimised the cost of social investor finance.

Limits on activities

Finally, when designing an outcomes-based contract, commissioners will need to establish what limits may be required to be placed on the activities of the provider.

It will be beneficial to minimise the constraints placed on activities to allow the provider the freedom to experiment and innovate. This is one of the primary reasons for introducing a Social Impact Bond.

As a minimum, the commissioner will want, however, to ensure the provider complies with the law. The procurement process should also check that the proposed core interventions have evidence of success, whilst allowing providers to develop the programme over time and recognising that investors will usually help screen out ineffective services. Similarly there may be some approaches to achieving the required social impact that are politically or socially unacceptable, such as paying people to change their behaviour. Where these are known at the outset the contract should specifically exclude these approaches.

There may also be a case for enabling the commissioner to terminate the contract if it becomes clear the Social Impact Bond is failing.

10 Budgeting for Social Impact Bonds

This section considers how Social Impact Bond funded activity might be budgeted. It aims to help commissioners both in the initial decision on whether to establish a Social Impact Bond and the subsequent implementation planning.

As noted in Section 5, we recommend that a feasibility study is usually required prior to procurement in order to assess whether the approach represents value for money in relation to other activities.

In addition, commissioners will usually need to consider three additional accounting and budgetary issues:

- Whether the Social Impact Bond delivery agency will need to be included in public sector budgets;
- Ensuring budgetary headroom for the Social Impact Bond payments;
- Matching the timing of costs and benefits from the Social Impact Bond.

Commissioners should ensure that they have the legal powers to fund Social Impact Bonds that cross traditional service and Departmental boundaries. In some cases, they may be constrained in the types of service that they can fund.

As with procurement regulations, budgeting for Social Impact Bonds will usually need to be assessed on a case-by-case basis, at least in new areas. Commissioners should seek independent advice when necessary. Social Finance will also seek to share the budgeting and accounting advice that we receive on new Social Impact Bonds where this is possible.

This section simply provides a very high level summary of issues. Appendix C describes the UK public sector accounting and budgeting framework and includes more detailed technical background behind some of the issues discussed here. Commissioners may find this Appendix helpful in informing requests for specific advice from their finance teams or advisors and should note from it how in most public bodies budgeting and accounting principles are closely aligned. CIPFA may also provide more general guidance to Local Authorities in the coming months and, in central government, commissioners may need HM Treasury agreement on Social Impact Bond budgeting.

Whether the Social Impact Bond delivery agency will need to be included in public sector budgets

The first issue that is sometimes asked in relation to Social Impact Bonds is whether the capital raising and direct operations of the Social Impact Bond delivery agency itself, rather than just the outcomes-based contract, should be included in public sector budgets. In other words, does the commissioning body need to show the internal operational finances of a Social Impact Bond Delivery Agency within its budgets?

For the activities of the delivery agency to be included in public sector budgets, the organisation would need to be classified as part of the public sector.

Whether organisations are classified as within the public sector or not is a decision for the Office of National Statistics (ONS). The ONS look at who controls an organisation (referred to as an ‘entity’). The most important consideration, among others, will be whether the public sector controls the majority of voting rights on the board.

In our view at Social Finance, and without seeking to pre-judge assessments from the ONS, it should be possible to structure Social Impact Bond delivery agencies so that the public sector does not have any significant control over them, let alone a majority control. In this case, the direct activity of the delivery agency in raising capital or managing its operations should not have an impact on public sector budgets. Such independent control will also be important for investors, who will want to be in charge if they are providing the capital, potentially in partnership with direct providers of services. The One* Service in Peterborough operates such a model. It delivers outcomes to the commissioner under contract, but the commissioner is not able to determine how the delivery agency operates.

The circumstances in which we believe that public sector control may be an issue, and therefore should be examined in more depth, are under a Joint Venture or public sector partnership arrangement or if any advisory group to the Social Impact Bond Delivery Agency had a large proportion of public sector appointees. In these circumstances, it will be particularly important to seek advice. Appendix C also includes some further details around the accounting treatment for Joint Ventures.

Ensuring budgetary headroom for the Social Impact Bond payments

Finance departments will need to assess the likelihood and potential profile of Social Impact Bond payments to ensure that commissioners have a sufficient budget to cover these payments.

Broadly, if future payments are certain in amount and timing at the point of contract signature regardless of outcomes, such that payments were required to be made irrespectively of whether a service was delivered or not, the commissioner will experience an impact on its capital budget.

Clearly, the types of Social Impact Bond contracts we are envisaging in this paper should not have such certainty. Payments due under them will depend on meeting agreed outcomes. Hence, in most contracts, although some level of payment is more likely than not to be made at some stage, the amount and timing of payment would be uncertain. In these circumstances, commissioners of all types should not experience any capital budget impact for these payments.

However, even if there is no impact on capital budgets, commissioners of all types will still need to ensure that there is budgetary headroom for the revenue costs when they are actually incurred. This stems from the likely accounting treatment for such amounts either as provisions or executory contracts. This issue is discussed in more detail in Appendix C, but in summary:

- All public bodies will account (and hence budget) for the Social Impact Bond contract as an executory contract if it can be terminated at any time and the commissioner is not likely to be committed to any significant future payments following such a termination. Examples of executory contracts include employment contracts.
- All public bodies will account (and hence budget) for future payments under Social Impact Bond contracts as provisions if the obligation to make such payments is certain but their amounts and timing are not;
- Local Authorities and Foundation Trusts will need to include any changes to each year's provisions balance arising from Social Impact Bond contracts in their revenue budgets for the years where payment is expected; and

- All other public bodies, such as central Government Departments, do not budget for provisions in the same way as Local Authorities, but will need to ensure that enough revenue budget is available for periods when the costs provided for are actually incurred.

Matching Costs and Benefits

When cashable savings would be used to make contract payments, it is important to think about the timing of likely savings and payments.

Ideally, Social Impact Bond contracts would be developed in a way that ensures that cashable savings and payments fall in the same financial year. However, in some of the examples we have noted in this paper, such as reducing NEETs or long-term health costs, it may be that outcomes payments need to be made prior to some or all of the savings. In these instances, commissioners will have two choices:

- If outcomes payments fall due before cashable savings result, but these savings' value and timing are highly certain at the time the outcomes payments are made, commissioners may be able to defer the payments' revenue budgetary impact until the cashable saving results. This stems from such payments being accounted for as 'prepayments'. However, the degree of certainty will need to be high and if cashable savings became uncertain this would create an unexpected budgetary pressure arising from the need to now account for the prepayments balance as either a provision or an expense item. In Government and non-Foundation Trust NHS bodies, these payments will also still impact on capital budgets if their total value exceeds £20 million and they will be made over more than one year.
- An alternative approach is to designate funds in advance for this purpose of paying for outcomes where savings will be generated in the longer term or there is great uncertainty in whether they will be cashed. The DWP Innovation Fund has taken such an approach. It has put aside £30 million at the start of the process.

In conclusion, commissioners need to think through these budgeting risks, generally seek to design a Social Impact Bond that minimises a mismatch in the timing of outcomes payments and savings if possible, and agree with the finance department how any mismatch will be managed in advance.

11 Conclusion

Social Impact Bonds are a new way to deliver improvements in social outcomes. Like any new approach, processes and skills will need to evolve in order to fully realise their potential. Commissioning is just one example of how systems will need to develop. At the other end of the Social Impact Bond structure, changes may also be required in the processes that traditionally govern investment decisions.

Such change can seem daunting. The temptation could be to simply avoid establishing Social Impact Bonds.

We think that such a response would be a mistake. As we have set out in this paper, there are already a range of promising approaches being developed to the commissioning and procurement of Social Impact Bonds. Much is common sense. Commissioners are also able to draw on emerging experience from peers and from specialist advisers.

We hope that this paper helps commissioners think through how they would take a Social Impact Bond from idea to implementation. Although each circumstance will vary, six 'do's' of good commissioning of Social Impact Bonds particularly stand out:

- Do invest in a feasibility study. Better outcomes and value for money should ensue if the commissioner has defined, in advance, the social outcome and gap in services, the target population, and the potential for cashable savings, investor interest and the key features of a contract.
- Do ensure that there is a dialogue with potential providers and investors through the process. Engagement can be prior to procurement and/or with a small number of potential organisations after an initial qualification process, such as through a two-stage process.
- Do establish a procurement process that has low costs for bidders. As Social Impact Bonds are needed in new, undercapitalised markets, there are unlikely to be players with deep pockets (neither social sector providers nor social investors). So it is even more important than usual for commissioners to establish simple processes and define their criteria in a way that ensures the process quickly focuses on one or a small number of providers. A simple two-stage process can be helpful. Finalising elements of the project design once a single preferred provider has been identified may also be helpful. In a very emerging market, commissioners may also need to consider covering some bid costs for those bidders shortlisted.
- Do ask bidders to demonstrate that they have secured, or have a good prospects of securing, both providers and investors. This process will eliminate speculative applications because investors will only back credible providers.
- Do consider collaborating with others in order to establish a Framework or to co-commission Social Impact Bonds. This will help build the market and enable investment to be raised at sufficient scale.
- Do seek to introduce processes, such as open book accounting, good contract management arrangements and independent evaluations, so that individual commissioners and the market can learn from the development of Social Impact Bonds.

By following these suggestions and the other approaches set out in this paper, we are confident that many Social Impact Bonds will be successfully commissioned in the coming years.

APPENDICES

Appendix A – Questions for Commissioners

The table below sets out some questions that will be relevant to commissioning a Social Impact Bond or other outcomes-based contracts.

1 **Strategic Fit** – Is there an identified and clearly articulated social 'need' or issue that is not currently being addressed (e.g. there is no provision or existing provision is inadequate)?	Yes – proceed to 2
	No – questions to be addressed include: What is the target population for the social issue (e.g. volumes, age range, and geographic area)? Does the need represent a gap in existing service provision, entirely new service provision or re-procurement of existing service provision? What interventions may support the social need, what evidence is there that these interventions are effective in achieving the desired outcome and (if applicable) how will the interventions fit into existing service provision? What is the likely time horizon over which the interventions and the outcomes that they aim to support will occur?
2 **Economic** – Is the outcome sought to address the 'need' capable of measurement and has its measurement been clearly defined?	Yes – proceed to 3
	No – questions to be addressed include: What metric(s) can be used as a proxy to evaluate the success of the intervention at delivering the required outcome(s)? What population size is required to ensure statistical significance? How can a baseline be structured against which the impact of the intervention can be measured?
3 **Economic** – Do the estimated cost savings generated from an improved outcome exceed the cost of the proposed interventions (e.g. are 'cashable' savings identified) and/or will the approach deliver greater value for money than alternative ways of meeting the outcome?	Yes – proceed to 4
	No- questions to be addressed include: Which public sector bodies will benefit from the outcomes delivered and in what quantum? What are the anticipated underlying costs of the potential interventions? Is there appetite from all beneficiaries to share in funding the cost of successful interventions? What are the existing value-for-money benchmarks for delivering the outcome?

4 **Commercial** – Has an options appraisal identified the optimal delivery structure for the outcome to be commissioned (e.g. is a Social Impact Bond the appropriate delivery mechanism)?	Yes – proceed to 5 No – questions to be addressed include: How does delivery fit with existing provision? (e.g. complementary, re-letting of existing service, new service) What (if any) statutory obligations need to be met by the commissioner? What alternative delivery options are there e.g. traditional procurement, incumbent providers?
5 **Financial** – Has the service to be commissioned been tested with the finance department to determine it is feasible/affordable?	Yes – proceed to 6 No – questions to be addressed include: What are likely to be the cashable savings arising from the use of a Social Impact Bond? What are the key risks and dependencies in realising such benefits? Who are likely to realise such savings (i.e. will all those departments that may benefit be involved in subsequent outcome payments)? Is there the ability to agree and account for differences in the timing of activity and costs and benefits realisation?
6 **Commercial/ financial** – Is the approach to incentivising the delivery of outcomes through the contact and payment mechanism clearly defined and articulated?	Yes – proceed to 7 No – questions to be addressed include: Has an optimal payment structure been identified? (by testing mix between milestone payments, mix of outcome and activity payments and 100% outcomes-based payments). Can financial penalties compensate for any potential reputational damage? How is failure defined and how can it be managed/rectified (given the potential lag between intervention and outcome realisation)?
7 **Commercial** – Has a suitable procurement procedure been selected which is both compliant with necessary procurement regulations and capable of demonstrating value for money?	Yes – proceed to 8 No – questions to be addressed include: Is the approach compliant with EU Procurement rules? Which of these procedures will ensure the best delivery outcome (i.e. competitive dialogue restricted tendering)? Is it appropriate to undertake market soundings through an expression of interest approach? Is the programme potentially “novel and contentious” (and therefore requires additional internal/external approval)?

8	**Financial** – Are the accounting implications of the service to be commissioned fully understood and approved by the finance department?	Yes – proceed to 9 No – questions to be addressed include: What are the relevant accounting and budgetary requirements (these differ across commissioners)? Which approach is likely to be acceptable? (e.g. executory contract, success bonus, book as prepayments, etc.)?
9	**Project Management** – Have the requisite capacity and capability to undertake the commissioning of the service been identified and committed?	Yes – the business case is complete with mechanisms for addressing questions 1–9 and is ready to be submitted to secure management approval No – questions to be addressed include: Has a committed project team been identified for the commissioning and on-going monitoring of the service provision? Are there any capacity / capability gaps within the in-house project team? Are there external parties that could provide advisory support for any gaps identified?

Appendix B – Procurement Regulations

Procurement within the public sector is governed by legislation cascaded down from the European Union (EU) and enacted into UK law in 2006 (The Public Contracts Regulations 2006 or 'the Regulations'). As described in Section 9, there are certain circumstances where the full remit of the Regulations may not apply. However, even in such circumstances the principles set out in the EU Treaty will still apply and therefore have to be taken into account.

The five fundamental principles that stem from the EU Treaty are:

- **Non-discrimination** – There should be no discrimination on the grounds of nationality;
- **Equal treatment** – There should be equal opportunity to tender for work. This means amongst other things that all suppliers must be given the same information and the same opportunity to submit tenders;
- **Transparency** – The procurement process should be characterised by predictability and openness. The contract documents must be clear and unambiguous and contain all the requirements in respect of the proposed procurement. This includes publication of the contract aware notice including the selection and award criteria;

- **Mutual recognition** – Documents, certificates and equivalent standards from other nations should be acceptable; and
- **Proportionality** – The qualification requirement and the requirement regarding the subject matter of the contract must be reasonable and commensurate with the goods, service or works being procured.

Applicability of EU Regulations

The applicability of the Regulations is determined by the size of the contract (thresholds) and nature of the service.

EC Procurement Thresholds

Generally, the Regulations apply to the award of contracts whose value equal or exceed specific thresholds. Details of the thresholds, applying from 1st January 2010 are given below. Thresholds are net of VAT.

	SUPPLIES	SERVICES	WORKS
Entities listed in Schedule 1[1]	£101,323 (€125,000)	£101,323[2] (€125,000)	£3,927,260 (€4,845,000)
Other public sector contracting authorities	£156,442 (€193,000)	£156,442 (€193,000)	£3,927,260 (€4,845,000)
Indicative Notices	£607,935 (€750,000)	£607,935 (€750,000)	£3,927,260 (€4,845,000)
Small lots	£64,846 (€80,000)	£64,846 (€80,000)	£810,580 (€1,000,000)

1 Schedule 1 of the Public Contracts Regulations 2006 lists central government bodies subject to the World Trade Organisation's (WTO) Government Procurement Agreement (GPA). These thresholds will also apply to any successor bodies.

2 With the exception of the following services, which have a threshold of £156,442 (€193,000): Part B (residual) services; Research & Development Services (Category 8); Some telecommunications services and subsidised services contracts.

Part A and Part B services

Part A Services (below) are subject to the full requirements. This means for instance, that the services must be advertised in the Official Journal of the European Union (OJEU). Part B are not subject to the full requirements.

Part A Services (full regime)	Part B Services (partial regime)
Accounting, auditing, book-keeping	Catering
Market research and opinion polling	Legal
Management consultancy	Security
Architectural, engineering, urban planning, landscaping and related technical services	Educational
Advertising	Health and Social
Building cleaning and property management	Recreational, cultural and sporting
Sewerage and refuse disposal	Other services
IT services	
Financial services	
Transport and courier services	
Maintenance and repair of vehicles and equipment	

Whether or not the Regulations apply is a matter of legal interpretation, and given the potential risks of challenge and the implications of the Remedies Directive, commissioners and contracting authorities are advised to seek independent legal advice on a case-by-case basis.

In addition to the application of the EU Treaty principles, procurements that fall outside the Regulations will still need to meet the requirements of Competition Law and comply with UK government policy on ensuring value for money. Usually the best way to demonstrate value for money is to run a competitive process. Hence, is often considered prudent to set up the process in a way that is similar to a public procurement under the Regulations to provide greater assurance that the procurement is structured to deliver value for money.

Enforcement and reducing risks of challenge

Contracting authorities are responsible for carrying out the correct procurement procedure from the outset. They carry the risk of breach of the Regulations: the remedies for which can include the setting aside of an awarded contract, fines and damages.

If the contracting authority awards a contract that should have been subject to the application of the Regulations fully and did not, then the risks vary depending on when they are challenged. Once a contract has been awarded there are also certain tools available to contracting authorities to mitigate the risk of challenge. For example, the contracting authority can notify OJEU of the award of a public contract, no later than 48 days after the award or conclusion of the contract. The effect of this is to reduce the time period that someone can challenge the award, from 6 months to 30 days. Alternatively, a contracting

authority may issue a Voluntary Ex Ante Transparency Notice ("VEAT") in the OJEU at least 10 days before the signing of the contract. A VEAT is a fairly new form, which exists solely to offer protection to the contracting authority. In effect, it is an 'insurance policy' against the risk that the contracting authority had been wrong in thinking that no OJEU advertisement had been needed at the beginning of the process.

Where the procurement does not fall within the scope of the Regulations, because they are Part B services or below the threshold, there is still a risk of challenge from bidders. However, the full range of remedies and enforcement options set out in the Remedies Directive will not be applicable.

Procurement procedures on the Regulations

We consider that most Social Impact Bond contracts will be in respect of Part B services and therefore have potentially greater flexibility in procurement approaches. If they do fall under the Regulations, they will need to follow one of four main procurement procedures: open, restricted, competitive dialogue and negotiated.

- The "open procedure": the contracting authority invites providers to bid directly for the contract in response to the Contract Notice. All of the providers interested may respond to the advertisement and bid the opportunity and the winning provider is then selected directly from the bidders. This procedure does not allow a pre-qualification process or any negotiation with bidders and assumes that the requirement can be fully specified in advance and that the full contractual terms are capable of being issued at the start of the procurement process. It is therefore not likely to be appropriate for Social Impact Bond contracts.
- The "restricted procedure": the contracting authority carries out a pre-selection from those who respond to the Contract Notice and invites those providers only to participate, which must be a minimum of 5 if 5 are available. This is therefore a two-stage process: short-listing, followed by submission of formal tender. The winning provider is then selected directly from the providers that have been invited to tender. This may be appropriate for Social Impact Bond contracts.
- The "competitive dialogue procedure": following the publication of a Contract Notice and a selection process (where at least 3 parties must be selected if available to enter into dialogue) the contracting authority enters into dialogue with potential bidders to develop one or more suitable solutions for its requirements and on which chosen bidders will be invited to tender. This should only be used for 'particularly complex' projects and may be appropriate for more complex Social Impact Bonds.
- The "negotiated procedure": following the publication of a Contract Notice and a selection process (where at least 3 parties must be selected if available to enter into negotiations) the contracting authority negotiates the terms of the contract with one or more providers. This procedure is limited to specific circumstances and should only be used when other procedures will not work, competition is not viable or appropriate, work is needed for research or development purposes, or where prior overall pricing is not possible. This procedure is stated by the UK government to be considered not generally available as it has resulted in poor negotiated results for contracting authorities.

Appendix C – Public Sector Accounting and Budgeting

Section 10 noted some of the budgetary issues that commissioners should consider in assessing the affordability of Social Impact Bonds and how budgets should be planned for.

This Appendix provides some background information on the technical budgeting and accounting considerations that influence these issues.

Budgetary assessments will be carried out under a budgetary framework in which budgets are determined under principles closely related to International Financial Reporting Standards ('IFRS')-based accounting practice. In some cases, budgeting rules differ from accounting rules, depending on the type of public sector body and activity (see box).

Budgeting and accounting rules

In broad terms:

- All UK Government and other public sector bodies prepare accounting statements under IFRS;
- The UK's fiscal and economic activity is recorded in the National Accounts, which the Office of National Statistics ('ONS') prepares under the European System of Accounts ('ESA 95').
- Government Departmental budgets follow IFRS accounting, except when the transaction's impact on the National Accounts is materially different to its impact on the Department's accounting statements. In such cases, budgets are determined under ESA 95.
- NHS bodies that are not Foundation Trusts follow Government budgeting rules, whole Foundation Trusts' budgets and accounts follow IFRS only with no reference to ESA 95 where fiscal impacts differ.
- Local Authorities account under IFRS but set budgets by determining their total expected revenue costs and the borrowing needed to finance their capital plan. This borrowing is then allocated over its repayment period or the useful lives of the assets concerned. Each year's borrowing allocation is added to the expected revenue cost as 'statutory adjustments' which result in a 'general fund' balance. Expected Government grants and non-domestic rate income are subtracted from the budgeted general fund balance to give a residual amount to be funded from Council Tax and charges to service users.

Whether the Social Impact Bond delivery agency will need to be included in public sector accounts

As noted in Section 10, this issue is about whether the delivery agency, the organisation managing the delivery of the contract and the spending of the investment, is classified as within the public sector.

This classification is solely a matter for the ONS but in general the following principles will be applied:

- An entity is considered to be distinct if it has its own governance process and publishes a separate set of accounting statements;
- An entity is likely to be considered as public if the public sector controls more than 50% of it through voting rights, or ownership of shares or other operational and financial control mechanisms.

It should be possible to ensure that any Social Impact Bond delivery agency does not have such public sector control since they will usually be wholly controlled by investors (as in the Peterborough Social Impact Bond), or some combination of investors and the independent service providers. Therefore, although decisions on classification are for ONS to determine alone, we expect that they would be classified to the private sector if appropriately structured.

However, if the commissioner is seeking to establish the Social Impact Bond as a Joint Venture or partnership or seeking control in some other way, such as through nominating many of the members of an advisory group or determining detailed operational policies, there is a greater risk of public sector classification for the delivery agency, hence requiring budgetary provision. This risk arises from the possibility that the commissioner has enough influence or control over the entity to need to consider the entity as a 'subsidiary'.

For completeness, we therefore include some background information on the accounting treatment of Joint Ventures.

Central Government Budgeting for Joint Ventures or Partnerships

Government departments apply IFRS-based accounting to stakes in other entities only when the entity is classed as lying within their departmental accounting boundary. Any other body is accounted for as an investment at the cost of that investment. This means that the department records how much it pays to obtain its voting rights in the entity, which will often be a nominal sum.

As noted in the introduction, whether an entity is classified as distinct and within the public sector is a matter for the ONS. If the entity is classified as distinct and within the public sector, and it generates most of its income from trading activities, it is a public corporation. Most of its transactions fall outside of the controlling department's budget. However any borrowing by the public corporation is charged to the department's capital budget. Consequently if a delivery agency is classified as a public corporation, the Social Impact Bond finance will be charged to the controlling department's capital budget.

NHS Budgeting for Joint Ventures or Partnerships

All NHS bodies will account and budget for interests in other entities under IFRS. This treatment will depend on the amount of influence or control that the public body has over the entity. The relevant accounting standards define:

- **Control** as the power to govern an entity's financial and operating policies so as to obtain benefits from its activities;
- **Joint control** as contractually agreed sharing of control over another entity such that the entity's strategic and operating decisions need the unanimous consent of all holders of joint control; and
- **Significant influence** as the power to participate in an entity's financial and operational planning but which is neither control nor joint control.

If a NHS body has control over an entity, the NHS body is the parent and the entity is fully consolidated. This means that any borrowing by the entity is added to the NHS body's borrowing and will need capital budget.

If the parent has joint control over the entity, a proportion of the entity is consolidated into the parent body's accounts. This consolidation may be on a line-by-line basis such that a constant proportion of the entity's assets, liabilities, revenues and costs are added to the parent's accounts. Alternatively, a proportion of the entity's net worth and profit or loss is added to the parent's balance sheet and income statement. Hence the entity's impact on the NHS body's budgets will depend on which option is adopted for accounting for the share as well as the size of that share.

If the parent has significant influence over the entity, a proportion of the entity's net worth and profit or loss is added to the parent's balance sheet and income statement and no addition to borrowing results.

Consequently, if a NHS body is capable of fully controlling an entity as a result of a desire to steer how the Social Impact Bond funded activity is managed and provided, there is a risk that all of the Social Impact Bond finance will impact the NHS body's capital budget. This risk reduces as the NHS body's control over the entity weakens.

Local Authority Budgeting for Joint Ventures or Partnerships

Local Authorities apply the same principles as NHS bodies in accounting for interests in other entities, with the key exception that these interests are recorded in a separate set of accounting statements whose impact on Local Authority budgets is relatively indirect. The borrowing by such entities is excluded from the statutory adjustments for borrowing undertaken directly by the authority. However, Local Authorities must apply a statutory adjustment for the cost of the investment in any such entity, usually represented by how much the authority pays to obtain its voting rights on the entity board. This amount must be allocated over the duration of the investment or 20 years, whichever is shorter.

What is a Long Term Liability?

IFRS defines a liability as an obligation arising from a past event to transfer future benefits. In comparison, ESA 95 defines a loan as a financial asset which becomes interest bearing unconditional debt. Consequently, the ESA 95 and IFRS definitions are closely aligned enough for budgeting to follow accounting and hence in Government or non-Foundation Trust NHS bodies, capital budgetary impacts result where long term liabilities are recorded for that activity. Likewise Local Authorities and Foundation Trusts will provide for the reduction of any long term liability that finances a capital investment in their revenue budgets for the costs of such investments.

Therefore, in Social Impact Bond funded activity, a commissioner would only record a long term liability where it:

- Guarantees some or all of the repayments by the provider of the Social Impact Bond finance in all events; or
- Must make payments to the provider at fixed or determinable times over more than one year regardless of the provider's performance.

Ensuring budgetary headroom

Capital Budget Impacts

Social Impact Bond payments will only impact public bodies' capital budgets if they result in long term liabilities.

We consider that it is very unlikely that Social Impact Bonds will create such long term liabilities if the investor's return is wholly at risk of the Social Impact Bond delivery agency not meeting its obligations under the Social Impact Bond contract. Likewise, if the commissioner's payments to the provider are not certain either in timing or amount, there will be no long term liability. Instead, commissioners will account for any requirement to make future payments as provisions.

Revenue Budget Impacts

A Social Impact Bond contract is more likely to be budgeted and accounted for as either an executory contract or a provision than a long term liability, due to the expected uncertainty in payments to the delivery agency.

Executory Contracts

An executory contract is defined in IFRS as one in which:

- None of the signatories to a contract have yet carried out any element of that contract; or
- All signatories have met their obligations under the contract to the same extent.

Hence if a Social Impact Bond contract is executory, the delivery agency would undertake the required activity, and the commissioner would pay for that activity as it is undertaken. Only where the delivery agency has not met an agreed schedule of activity or the commissioner has not paid all amounts due to the delivery agency for the activity undertaken to date would either party have an obligation to the other.

For all public bodies, executory contracts are budgeted for in the same way as their accounting, such that costs are charged to revenue budgets as incurred.

If the commissioner could not terminate the contract for reasons other than delivery agency default with no payment due after the termination, but the future payments are uncertain in timing and amount (i.e. no long term liability), the commissioner would account and budget for the Social Impact Bond contract as a provision.

Provisions

IFRS defines a provision as a liability of uncertain timing or amount; hence if a body has an obligation to make a payment from a past event but the amount or timing of this payment is uncertain or depends on circumstances outside the commissioner's control, it will account for this obligation as a provision. The provision is usually measured on the commissioner's balance sheet as the total value of the payments that may fall due multiplied by the likelihood of them being due at the balance sheet date. So, for example, if the commissioner believes that there is a probability of 50% that £50,000 will be paid within the current year, the provision is £25,000.

Additions to or subtractions from a provision balance are charged or credited to the entity's income and expenditure account. Hence in the above example, the balance sheet is credited with £25,000 and the income and expenditure account debited with that amount when the provision is made. When payment is actually made, the body credits cash with the payment and debits the provision. If the actual payments are greater than the provision, the extra is debited to the income and expenditure account. If less, the provision is either carried over to the following year or credited to the income and expenditure account depending on the likelihood of further payments being due.

If the commissioner believes that it may need to make payments to a provider but either has not yet agreed to make these payments, or cannot reliably estimate their value and likelihood, it will account for this possibility as a contingent liability. There are no ledger entries for contingent liabilities; instead the body discloses the contingent liability including a best estimate of the amounts and timing of payments in notes to its accounts.

ESA 95 does not require accounting entries either for provisions or contingent liabilities.

Budgeting for Provisions

In Government and non-Foundation Trust NHS bodies the differences between the IFRS and ESA 95 treatments of provisions mean that they are budgeted for under ESA 95, which means that:

- The provision has no capital budget impact; and
- Changes to the provision balance are recorded in Annually Managed Expenditure at the time the provision is made then charged to the Revenue Departmental Expenditure Limit when the payment is made.

This means that Government and non-Foundation Trust NHS bodies need not budget for Social Impact Bond funded activity payments in advance of them falling due. However these payments must still be budgeted for at the time they are made, so such bodies must ensure that they can be met within their available revenue budget.

Local Authorities and Foundation Trusts do not refer to ESA 95 in their budgeting; hence the potential capital budget impact of provisions depends on whether such amounts are included in their charges to revenue budgets for the costs of capital investments.

Local Authorities are not required to make statutory adjustments to spread the cost of a provision. However changes to provision balances recorded in the income and expenditure

account are also made to the general fund, meaning that such transactions must be budgeted for as they are accounted for.

Foundation Trusts are not required to include provisions in their borrowing totals. However income and expenditure account transactions from provisions will be included in the risk indicators used by Monitor to assess their financial risk rating.

Matching Costs and Benefits

For all public bodies, budgets for costs must be provided to match the time that these costs are recorded in the bodies' accounts.

If Social Impact Bond payments are to be funded from savings in other budgets, the savings must be recorded approximately simultaneously with the recorded costs of the activity.

IFRS contains clearly defined principles for the timing of recognition of revenue, and states that in general that the cost of an activity should usually match when that activity's revenue is recognised. In the public sector, activity rarely generates revenue but usually results in a service being provided, or an increase in service potential. Hence, following this principle, the cost of a Social Impact Bond-funded activity would normally be recorded when that activity takes place, which will usually pre-date its benefits, although post-dating may also occur if other activities are scaled down in anticipation of future reduced demand.

As discussed above under revenue budget impacts, costs are either charged to revenue budgets as incurred if the activity is an executory contract, or in Local Authorities only, some costs are charged in advance of them being incurred if the commissioner has to account for them as a provision. In central government, the provision is charged to Annual Managed Expenditure when made but the cost when incurred is charged to the revenue budget in the same way as an executory contract. As a result, matching budgeted cost and benefit will rarely be possible in a Social Impact Bond funded activity.

However commissioners may be able to defer charging of Social Impact Bond activity costs to revenue budgets if the benefits' value and timing are both highly certain. In this case, the body could account for any payment made ahead of its benefits as a prepayment, which is recorded on the balance sheet under current assets, rather than charged to the income and expenditure account. The prepayment will then be charged back to the income and expenditure account when the expected benefits are received. It is expected that this treatment will only be applicable in rare circumstances due to the nature of Social Impact Bond funded activity and the inherent uncertainty in the timing and amount of benefits arising from it.

Government departments and non-Foundation Trust NHS bodies will include any prepayment balance in their capital budgets if the total prepayment value exceeds £20 million and the prepayment represents benefits due over more than one year.

Local Authority and Foundation Trust budgeting for prepayments will follow their accounting treatment in that revenue budgets will be impacted when the prepaid service is received, or in the case of Social Impact Bond funded activity the benefit results.

In all public bodies, if the high level of certainty in timing and amount of saving is reduced, the accounting and budgeting treatment will need to be reassessed and it is possible that any cash payment accounted for as a prepayment will need to be charged to the income and expenditure account and hence will impact the revenue budget earlier than expected. Commissioners will therefore still need to ensure that revenue budget is available to meet any such events.

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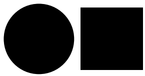

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