

CBI BRIEF

Counting the cost

Full cost comparison between public service providers

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Unless the true cost of public services can be measured and compared, it is impossible for the government to know if it is delivering value. Achieving full cost comparison between competing providers in public procurement is vital to ensuring better value and higher quality public services for taxpayers and service users. At a time when demands on public services are increasing and the need to deliver efficiencies is more urgent, knowing what services really cost is vital when making decisions on who is best placed to provide a service.

The provision of public services has changed significantly in recent years. In many areas the public, private and voluntary sectors are competing against each other to provide them. This healthy competition has helped deliver innovation, better quality services and value for money for the taxpayer. The CBI believes competition must be used effectively if we are to transform the UK's public services and make them more responsive to the needs of people who use them.

But, the rapid development of a mixed economy in public services has led to market distortions. Providers from the public sector still compete with an unfair advantage over private and voluntary sector organisations because many costs remain hidden. The real losers from this situation are the users and funders of public services, who miss out on having the best service possible and may end up paying more for it through higher taxes.

Full cost comparison is part of ensuring a level playing field for providers from all sectors. The cost of services needs to be measured on the same basis regardless of which organisation is providing them so we can know which offers the best mix of quality and cost. This means including elements such as pensions liabilities, VAT, overheads involved in the bidding process and the cost of depreciation on capital such as buildings and equipment. Too often, these costs are ignored in public sector costings.

Government still has a poor record of knowing exactly what it spends on services. Successful businesses know the costs of running an operation. Transparency and fair competition demands the public sector should adopt the same rigour, so that we can more clearly identify the best provider.

Competitive neutrality – a level playing field – is an industry-wide issue. Progress by the government towards competitive neutrality has so far been piecemeal, with individual departments focusing on isolated commissioning and procurement issues rather than an overall approach to the fundamentals of market design. This means anomalies which distort the market remain.

To address these concerns, the CBI published a major report in 2006, *A fair field and no favours*.¹ It looked at some of the unfair advantages such as a failure to take into account the whole-life cost of a contract, differing inspection and regulatory regimes for public, private and voluntary providers and inequalities in the application of VAT. Two years on, these issues remain and continue to act as barriers to better quality public services and better value for the taxpayer. The government must address these issues to achieve the level playing field crucial to encouraging new providers to enter, invest and innovate in the market for public services so that they continue to improve.

Full cost comparison is at the heart of competitive neutrality, and our research shows that it is lacking across a wide range of public services. That is why we have revisited our 2006 report to assess progress, highlight areas where action is needed and provide recommendations. It is not possible to cover every aspect of competitive neutrality in this brief, but full cost comparison illustrates many of these wider issues.

Achieving full unit cost comparison – for example the cost of a stay in hospital or a prison place – and competitive neutrality will require a government-wide approach and a real push from the Treasury. This brief sets out why competitive neutrality matters for the public, highlights four key barriers needed to achieve it and makes recommendations to tackle the issues. The CBI wants to see decisions in public procurement processes which take into account:

- Comparable pension costs
- VAT rules applied consistently
- Running costs accurately measured
- Depreciation properly accounted for.

CBI RECOMMENDATIONS

Competitive neutrality is a complex issue affecting a wide range of public services. To achieve a level playing field and improve the quality and efficiency of public services, the CBI recommends:

- A Treasury-led, government-wide review of competitive neutrality policy and practice in public services should take place as soon as possible
- The Treasury should develop a consistent approach to pension costs for all employees transferred from the public to the private sector
- The Treasury should conduct a review of the VAT regime in public services and consider a taxation equivalence regime for public sector providers to ensure tax neutrality
- The Office of Government Commerce should develop guidelines applicable to all government departments, agencies and local authorities to ensure they operate a proper unit costing approach
- The Treasury should develop guidelines to establish effective cost of capital and depreciation arrangements for public services.

“If providers are not convinced of the fairness and sustainability of public service markets, they are less likely to enter, invest and innovate.”

Why competitive neutrality still matters

Artificial barriers to fair competition – such as a lack of full cost comparison – create market distortions and mean public spending is not directed to the most efficient providers. This can result in a decline in social savings, undermine the credibility of public procurement and lead to less competitive markets. If providers are not convinced of the fairness and sustainability of public service markets, they are less likely to enter, invest and innovate.

This affects citizens as both taxpayers and public service users. As taxpayers, the public wants value for money. And while value for money is not simply an issue of cost, an inability to compare the true cost of similar services makes it impossible for government to know if it is getting the best deal for taxpayers. Further, without proper comparative costing, public service users could be receiving poorer quality public services in one area than another, despite services apparently costing the same.

This can result in existing providers being commissioned to provide a service despite not delivering best value. It can also mean providers from the private and voluntary sectors are dissuaded from entering the market for fear of unfair competition. In markets such as those for prisons or residential care, where alternative provision already exists,

the lack of full cost comparison can result in services offered by the private and voluntary sector being wrongly regarded as more expensive than existing public sector provision.

Full cost comparison can help public sector commissioners by giving them a clear picture of the scale of their investment in public services and what return they are getting on that investment. This is vital. The Comprehensive Spending Review (CSR) settlement for 2008-11 has given most government departments smaller increases in budget than in previous years. In this climate, value for money is more important than ever.

The best public service commissioning is achieved with the fullest market intelligence. Full cost comparison must be adopted as a fundamental part of the public procurement process. Some parts of government have recognised the importance of competitive neutrality (Exhibit 1). But, some of the greatest barriers in the mixed economy of public services are beyond the capacity of individual departments and agencies to rectify. While detailed sectoral analysis is necessary in order to understand what competitive neutrality means in particular services, there are also cross-cutting issues that can only be resolved at a whole-of-government level.

EXHIBIT 1

Departmental initiatives on competitive neutrality

A number of government departments have recognised competitive neutrality as an issue and sought to address it. The CBI urges individual departments and government as a whole to build on these initial steps.

- **The National Offender Management Service (NOMS)** has recognised competitive neutrality as an issue in criminal justice services. The original remit of NOMS expressly stated that it intended to commission services from the best provider. In 2006, NOMS published a prospectus on market development on this basis, although experience to date has demonstrated a lack of practical support for a level playing field
- **The Department of Children, Schools & Families (DCSF)** organised a ministerial seminar into competitive neutrality issues in children's services in mid-2007. The seminar was attended by senior officials and provider representatives and identified a number of key issues. Competitive neutrality

was also identified as an issue in the DCSF paper of May 2007, *Delivering better children's services through better market development*,² but this has not resulted in further action

- **The Department of Work & Pensions** launched its own review of competitive neutrality in the markets it manages in May 2007. This reflected many of the recommendations called for in the 2006 CBI report, *A fair field and no favours*³ and represents a useful first step towards removing these barriers which will be tested in the new round of flexible New Deal contracting
- **The Department of Health's 2007 Commissioning framework for health and well-being**⁴ recognises the value of using competition to create a National Health Service better able to respond to the needs of individual patients. The NHS's *Principles and rules for cooperation and competition*⁵ document, issued in December 2007, set out fair competition rules for primary care trusts to apply to all providers, and we await their full implementation.

A lack of competitive neutrality is having an impact on core public services at national and local level. Notable examples include probation sub-contracting, the costing of private prison places, school support services and Connexions services for young people. In the long term, the CBI believes government needs to adopt a competitive neutrality framework for all its public service markets to ensure the best provider is chosen at all times.

RECOMMENDATION 1

A Treasury-led, government-wide review of competitive neutrality policy and practice in public services should take place as soon as possible

Barriers to achieving competitive neutrality

Competitive neutrality is not just a principle – it makes a difference to public services and full cost comparison is central to this. Full cost comparison is an illustration of continuing competitive neutrality issues arising in the way public services are commissioned and procured. This can be seen in four key areas: pensions, VAT, overhead costing and depreciation.

Public sector pension costs must be comparable

Public sector pension costs remain a major barrier to a level playing field in public service markets and therefore to market entry for providers in a number of sectors – most notably health, local government and criminal justice. Pensions are a substantial cost in providing many public services, for the simple fact that staff are a vital part of delivering these services and much of the total budget is taken up by personnel costs.

The government took bold and successful steps in the Pensions Act 2004 to ensure private sector companies recognised and acted on the true cost of their direct benefit schemes. Yet the contribution made by public sector providers to existing public sector pension schemes are typically significantly lower than the amount required by a private sector firm to provide equivalent benefits. The issue of public sector pension costs is one which the government needs to resolve in the long term, but in the short term it must act to ensure a level playing field – both in the way pensions costs are accounted for in commissioning for services and in accounting for pensions in delivering services.

Where staff are transferred from the public sector, new providers are usually required to guarantee their public sector final salary pensions. But private sector providers are not always allowed to join existing public sector pension schemes – which have a fixed rate for employer and employee contributions – and to set up similar pension provision on the open market requires an employer contribution of around 30% of an employee's salary – more than double the contribution for most public sector schemes. This cost increase not only acts as a barrier to market entry, but the failure to account for the full cost of pensions under public provision ensures public sector organisations have an unfair competitive advantage.

Uncertainty also comes from inconsistent application of rules designed to protect employees which guarantee them 'broadly comparable' terms and conditions when they are transferred from one employer to another. Private providers fully respect this principle but have encountered difficulties in interpreting how government departments are using the 'TUPE' rules which regulate it with regard to pensions. In local government and health, pension costs are a significant barrier to competitive neutrality. In education and welfare to work, mixed messages have contributed to uncertainty amongst providers. This uncertainty needs to be addressed.

Local government

Under current regulations, suppliers transferring employees to the private sector in local government contracts can either enter them into a scheme approved by the Government Actuary's Department (GAD) which offers 'broadly comparable' benefits, or they can obtain Admitted Body Status (ABS) to the Local Government Pension Scheme (LGPS) and make contributions to that. In theory, no preference is given to these options. In practice, ABS is favoured because it allows employees to continue to remain in the local government scheme and suppliers avoid the cost of setting up a comparable scheme. But there are problems with the ABS option in practice as it undermines best value principles and prevents a level playing field:

- **Contractors have no direct control over pension costs** – they cannot influence contribution rates or the future cost of scheme benefits. Despite this, accounting rules require providers to carry pensions costs on balance sheets,⁶ which impact on their ability to tender for new contracts

- **Asymmetric risks** – despite bearing all the risk, contractors are liable for any deficit at the end of a contract, but their benefit from any surplus is extremely limited.

Local authorities sometimes stipulate the ABS route in contracts, and suppliers have encountered significant problems with attempting to manage long-term pension risks within the lifetime of five to ten-year contracts.

The CBI's suggested solution is to establish full 'pass through' arrangements to ensure only risks under the control of the contractor are transferred from the contracting authority. These include pay increases and ill-health retirements above what is considered reasonable and set out in the contract. The contracting authority should be responsible for any increase or decrease in the pension contribution rate above or below that set out in the initial contract, or when the change is attributable to investment risk, changes in how well a pension fund is performing or an increase in the deficit. Furthermore, any surplus or deficit in the funding of the pension scheme at the end of the contract should be the responsibility of the local authority.

Healthcare

NHS Admitted Body Status is only available to not-for-profit organisations and for-profit companies owned by clinicians. NHS employers contribute 14% of employees' salaries to their employee pension scheme. But, this is substantially below the true economic cost of the scheme. To deliver the same pension benefits in an equivalent scheme a private provider would have to contribute the equivalent to 30-40% of an employee's salary to their pension fund. Even at this rate, the private contractor's liability is not capped, whereas that of an NHS trust is. The private sector also has substantial administration fees in complying with government and fund actuaries.

This distortion of the market has made it very difficult to transfer services to alternative providers. Some attempts have been made to have staff seconded from the NHS so that pension liabilities do not pass over to providers. This causes uncertainty over whether an alternative provider could be judged liable for full pension contributions retrospectively. In any benchmarking of public and independent sector costs, or in any competition between the two sectors, public providers will enjoy a significant cost advantage.

Education and skills

Since 2005 private providers have been contracted to deliver Offender Learning & Skills Service (OLASS) provision on behalf of the Learning & Skills Council (LSC). Previously, much of this activity had been delivered by local further education (FE) colleges, meaning that a number of employees transferred over to private providers under the TUPE regulations. A lack of clarity on this issue and inconsistent application of two major policy developments – through 2004 Treasury Guidelines on public sector pensions and revised TUPE regulations in 2006 – has discouraged providers from entering this market. The CBI supports TUPE as a sensible way of protecting employees but believes the TUPE regulations must be fairly and consistently implemented.

Furthermore, FE colleges are able to provide final salary schemes under the Teachers Pension Scheme, where they pay a contribution of 14% of salary. Private providers are not allowed to join this scheme despite offering exactly the same service. Setting up an equivalent scheme requires employer contributions of around 30% of salary – increasing private sector costs by 16 percentage points in comparison with FE competitors. This in effect makes offender learning a virtual FE college monopoly.

Welfare to work

The issue of pensions and TUPE liabilities at a contract stage has recently arisen in the Department of Work & Pensions (DWP's) approach to welfare to work. Pensions are a major part of TUPE costs so decisions on how to apply TUPE have a direct impact on costs for providers transferring staff. The DWP's Commissioning Strategy, which sets out expectations for providers around TUPE in its Code of Conduct, states, 'we are prepared to disregard TUPE costs in deciding on contract award'.⁷ This was put into action in tendering for the New Deal for Disabled Provision in January 2008. The DWP issued a statement making clear that, 'In order to maintain the integrity of the procurement process, any identified TUPE costs ...will be disregarded for the purpose of calculating the bid unit cost to be used during the value for money assessment of your bid.' This pragmatic approach by the DWP ensured the evaluation of the tender applications was carried out on the basis of predictable delivery costs rather than speculative TUPE liabilities.

But this has not been followed through consistently for all DWP contracts. In one recent instance the DWP accepted bids from a range of providers including some who tendered on the basis that TUPE applied and one provider on the basis that it did not, resulting in a significant difference to their overall costing of the bid as well as undermining any risk evaluation by the DWP on contract profit levels.

The provision specification accompanying invitations to tender for Flexible New Deal issued in March 2008 included an annex, where providers were advised of the likelihood that TUPE regulations would apply.⁸ This has since changed and a recent notice to providers in May 2008 stated that, while TUPE is applicable to the transfer for work from Jobcentre Plus to the new supplier, Jobcentre Plus will redeploy all existing New Deal staff prior to the start of the new contract, meaning no compulsory transfer of any DWP staff to successful bidders for Phase One contracts.⁹

This is confusing and results in mixed messages being sent to the market. It also makes it difficult for providers who operate in a range of public service markets to provide consistency in the cost of similar services commissioned by different departments and leads to a general lack of certainty across the market.

RECOMMENDATION 2

The Treasury should develop a consistent approach to pension costs for all employees transferred from the public to the private sector

Inconsistent VAT rules are applied

Rules for payment of Value Added Tax (VAT) are based in part on whether the funding for a service is considered a grant or a consideration for a service. The uncertain distinction between these two categories can disadvantage public, private and voluntary providers alike, depending on the sector and the service – even when providers are operating similar services in similar markets. This leads to distortions in the market which affect value for money for the taxpayer and the development of innovative and more joined-up services.

- **Public sector organisations** are VAT exempt (except when trading, they cannot claim back VAT on inputs, which the private sector can). This means, for example, that FE colleges and higher education institutions cannot claim back VAT when providing commercial services such as employee training courses to businesses. This gives the private sector a 17.5% price advantage
- **Voluntary sector providers** cannot claim back VAT for inputs under a contract, but are generally exempt from corporation tax and business rates. This gives them advantages in areas such as social care, but not in childcare. In the case of childcare and children’s centres provision, the VAT payable by different providers has led to significant distortions of the market
- **Private sector providers** can claim VAT rebates on inputs as the result of a contract, but not as a grant – giving in-house providers a 17.5% competitive advantage on price. For Connexions Partnerships – which provide information advice and guidance for young people – VAT has been a significant barrier in market development. An HM Revenue and Customs VAT ruling in 2004 gave a 17.5% competitive advantage to in-house provision on the basis that grant-aided partnerships providing services do not pay VAT, while those which manage contracts with independent suppliers do (case study 1). This undermines the government’s objective of opening up this important market as part of its aim of improving services to young people.

“Differences in VAT regimes between providers ... are increasingly anachronistic now the government is committed to a mixed market of provision.”

Differences in VAT regimes between providers are for the most part due to historic public policy decisions which made sense when public service provision was largely a state monopoly, but are increasingly anachronistic now the government is committed to a mixed market of provision. This can be illustrated by the example of social housing (case study 2).

The current conflicting effects of VAT on different providers suggest the need for an approach which allows for taxation to be properly taken into account when comparing the cost of public services. There are several ways to approach taxation equivalence between providers. Governments in Australia have operated a taxation equivalence regime since the 1990s under which public sector bodies are nominally charged the same tax as alternative providers when accounting for the full cost of public services.¹⁰

In the UK, tax equivalence can largely be addressed by central government departments and agencies through accounting changes (although in practice, given the complexity of VAT rules, this will require some deliberation). In the case of services provided by local government, accounting changes can ensure the most efficient provider is selected, but broader policy changes would need to be considered to ensure the local authority is not disadvantaged through using competition.

CASE STUDY 1

Connexions Partnerships liable for VAT

Connexions is a public careers, counselling and advice service for young people aged 13 to 19. It was created in 2000 to offer support and advice on education, housing, health, relationships, drugs, and finance. Connexions works closely with many other services – particularly those within local government such as the youth offending teams, teenage pregnancy workers and children’s services, as well as housing associations, Jobcentre Plus and others. Alternative providers have been delivering careers services since 1994.

VAT has been a significant barrier in market development. An HM Revenue and Customs VAT ruling in 2004 gave a 17.5% competitive advantage to in-house provision on the basis that grant-aided partnerships providing services do not pay VAT, while those which manage contracts with independent suppliers do.

This issue has been thrown into sharper focus by the 2004 Children’s Act which created children’s trusts, led by local authorities. A three-year transitional

period ran from 2005 to 2008 as responsibility for commissioning Connexions services has been transferred from Connexions Partnerships to local authorities. VAT has since been used as a justification for taking services back in-house by many local authorities, irrespective of service quality and the problem remains, despite repeated requests by providers and by the CBI to restore the level playing field.

CASE STUDY 2

Housing repair costs by private providers not VAT deductible

There are 2.3 million social homes owned by housing associations in England and 4.2 million owned by local authorities. The number of housing association homes is growing while the number of local authority homes is reducing as a result of the ‘right-to-buy’ policy and transfer of housing stock to housing associations.

In 2005-6 the turnover of housing associations was more than £9bn, with

£1.5bn spent on repairs and £7.5bn spend on management and other services. Of the latter, a recent joint Housing Corporation/Audit Commission study judged that savings in excess of £230m a year were possible through better procurement and that some two thirds of the £7.5bn should be outsourced.¹¹

VAT is a key inhibitor to outsourcing of housing association management.

One reason consistently given by housing associations about why they do not consider outsourcing housing management is the current VAT rules. These mean that external providers of such services to housing associations are subject to VAT and must therefore make savings in excess of 17.5% to offer any direct benefit to the housing association.

RECOMMENDATION 3

The Treasury should conduct a review of the VAT regime in public services and consider a taxation equivalence regime for public sector providers to ensure tax neutrality

- Mistrust between local authorities and independent private providers
- A lack of clarity about, and understanding of, in-house costs.

Underestimating running costs undermines comparability

All services have running costs which are part of the overall cost of that service. These include items such as the cost of premises (including mortgage costs), maintenance and utility costs and other costs such as telephones and IT services. In the case of public services, a full cost comparison of these costs and their impact on bidding for contracts should include the lifetime costs of achieving the service.

Public sector bids tend to underestimate the true cost of overheads. It has even been argued that, in some cases, in-house providers simply do not know what their costs are. Where the cost of bidding for contracts is high, the existing service provider can benefit – especially when in-house resources are not available to other bidders. This makes a like-for-like comparison impossible and means taxpayers – particularly local taxpayers – do not receive best value from the resulting service.

Children’s services are a good example. A Department for Education and Skills (now DCSF) report into children’s service markets found a perception among public sector commissioners that private residential care and foster care was more expensive, even though this was not substantiated by like-for-like data.¹²

Produced by PriceWaterhouseCoopers (PwC), the report found a number of barriers to developing greater transparency in cost which resulted in the local authority assuming the in-house provider was the best option. These included:

- The potential conflict of interest within a local authority that commissions and provides – as is the case in the ‘majority of authorities’¹³

“Authorities all think we charge too much money, but they’ve no idea about what their own costs are.”

The PwC report also noted that independent and in-house providers were often not providing the same level or quality of services. It suggested that wrap-around services such as additional educational support, psychologists, play therapy and others added cost to the system and remained a problem for in-house agencies to deliver. For in-house services, however, the cost of these inputs is often borne by other departments and agencies such as the primary care trust. This led an independent fostering agency to conclude, “Authorities all think we charge too much money, but they’ve no idea about what their own costs are. They think it’s just what carers get paid and a bit of social worker time and that’s it.”¹⁴

The report recommended a consistent and like-for-like understanding of the costs faced by all types of providers: a generic template could be sent to all local authorities showing how to account for in-house costs. Further, better visibility of profits made by providers might support a better sense of trust and challenge misperceptions that developed as a result of incomparable data between different providers and in-house provision.

Authorities such as Devon County Council have moved towards operating an internal cost regime for school support services, but most others still do not include the full overhead cost of buildings and access to local authority services when assessing in-house bids. These costs can include everything from IT to human resources support and can have a significant impact on the headline price.

Prisons are another area where costs are not measured effectively. HM Prison Service has a range of financial analysis tools, but a recent review of the future of prisons by Lord Carter of Coles found significant room for further improvement. The review sought to define the true cost of services, using the example of HMP Blakenhurst, and make a number of recommendations as to how cashable savings could be achieved and financial management could be improved in HM Prison Service.

To test this, a specialist firm of accountants analysed the cost increases at HMP Blakenhurst from 2001/02 (when the management of the prison was transferred to HM Prison Service from a private provider) to the present day. All additional sources of funding since 2001/02 were examined along with any changes in physical characteristics and activities – including new prison places, changes in regime and the introduction of intervention programmes.

An ‘efficient’ cost was then established by taking a view of what the current cost of HMP Blakenhurst would be if it were based on the original service level agreement price. Consultation with HM Prison Service validated and modified the initial figures. This process suggested the current running cost of running HMP Blakenhurst was significantly higher than that which would have been the case if the original service level agreement with the private sector were still in place. This increase in cost was not initially apparent from Prison Service data.¹⁵ Lord Carter placed considerable emphasis on the significant increase in costs found at HMP Blakenhurst, but a figure for this increase has not been released by the government.

RECOMMENDATION 4

The Office of Government Commerce should develop guidelines applicable to all government departments, agencies and local authorities to ensure they operate a proper unit costing approach

Failure to account for the cost of capital

The cost of capital and depreciation of public sector assets is another significant issue in unit cost comparison. Were this to be treated on a commercial basis it would give a much better measure of the true cost of services – as capital assets can contribute a significant level of overall cost –

particularly in prisons, hospitals and schools. Treasury *Green Book* rules are not explicit about how the cost of capital assets should be treated and addressing this would remove a further barrier to full cost comparison.¹⁶ This is important because investment costs can have a significant effect on whether a provider enters the market.

Public sector providers are often able to borrow at rates significantly below the market rate paid by other providers – possibly because lenders believe that governments will not permit their providers to default on liabilities. But, the rate of borrowing does not reflect the underlying riskiness of the activities public sector providers are engaged in as it does for private sector providers. For these, the risk of cashflows not meeting liabilities is shifted from banks (or other providers of finance) to taxpayers, but this does not mean the riskiness of the activities has changed. The cost of capital that should be applied to public providers should reflect the underlying riskiness of the activities they are engaged in, not the rate of borrowing, if this includes implicit guarantees of support from government.

Other benefits can also extend to organisations which receive direct government grant funding, having a revenue stream like this can make capital borrowing easier. For example, housing associations receive revenue from the government for providing social housing. This gives them significant reserves which allow for capital borrowing at rates lower than standard commercial rates. This is one reason why major bids for housing Private Finance Initiative (PFI) contracts have come from housing associations, but the capital they use has effectively come from the public purse.

There are also concerns that NHS tariffs do not reflect new capital costs. Payment-by-results tariffs – which determine the cost of a unit of treatment – are set to equal the national average of trusts’ total costs, a proportion of which represents capital costs. But the proportion of capital costs varies across trusts because some operate old, fully depreciated assets while others operate new buildings. This means that basing tariffs on the average of total costs will overfund trusts with lower than average capital costs and underfund those with higher than average capital costs. Most new hospitals are PFI schemes, so it is likely that hospitals with large PFI schemes will be underfunded and therefore more likely to incur deficits.

Depreciation is also a significant issue in comparing the cost of services over time. Including the cost of depreciation of assets in overall bid costs is common practice in the private sector and required for long-term and PFI contracts. PFI schemes often include a lifecycle fund, which is money set aside by the private sector provider to cover maintenance and refurbishment for the whole life of the contract. This ensures maintenance funds are ring-fenced and facilities do not subsequently become run-down as has been the case in the past for some public sector facilities.

But, as the example of prisons illustrates (case study 3), the public sector does not include the cost of depreciation of the value of the prison estate in its calculations for the costs

of providing a prison place. This is in contrast to the private sector, which must do so as a contractual obligation. This is starkly illustrated by the fact that a significant proportion of the recent £1.2bn announced for building new prisons will in fact be used for the replacement of 5000 public sector prison places currently unfit for purpose.

RECOMMENDATION 5

The Treasury should develop guidelines to establish effective cost of capital and depreciation arrangements for public services

CASE STUDY 3

Cost comparison between private and public prisons

Contrary to currently quoted data, private sector prisons cost less than those in the public sector. The regularly quoted comparative costs of the provision of services in prisons paint a picture of private sector provision costing the same or more than public sector provision.

In fact, the cost of private sector provision is markedly lower because the figures used for the comparison include significant elements of cost in the private sector figures not included in the public sector figures. A comparison of the

costs of a private sector prison and the average for the public sector equivalent illustrates the point.

Official figures show:

- A private sector prison has an annual cost per prisoner of £29,000 a year
- The average for a similar category B male local public sector prison is £28,000¹⁷

But:

- The quoted private sector costs include capital repayment, depreciation, pensions and organisational overheads – none of which are included in the public sector comparator
- Subtracting just the capital repayment costs would lower the private sector comparator to £21,000
- Taking the other elements into account would increase the differential even more.

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