Full cost recovery in VCSE contracts

Research into the experiences of Kent County Council's VCSE partners in public service commissioning

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Executive summary

The third sector can be a vital partner in delivering a range of public services, from social work, to domestic violence support, to providing community transport services. Using their knowledge, trust amongst local communities, and ability to act nimbly and innovatively, Voluntary, Community and Social Enterprises (VCSEs) can deliver better outcomes for service users and taxpayers.

This partnership is usually in the form of contracts commissioned by a local authority to be delivered by a VCSE. However, these contracts often do not cover the full cost of the work. NPC's State of the Sector research found that most charities pre-pandemic would subsidise their contracts from other income. This is likely to continue, as inflation erodes the value of existing contracts, and with NPC's research showing a more competitive market as more small and medium-sized charities seek to deliver public contracts.

We've been working with Kent County Council (KCC) to understand how Full Cost Recovery (FCR) is understood in relation to commissioning. FCR generally refers to paying providers enough to cover the full cost of delivering the contract at the agreed quality. However, as part of this research, we identified a lack of shared agreement or understanding on the definition of FCR. In this report, we examine why this and other challenges relating to FCR occur, and suggest ways to achieve a mutually productive partnership between local authorities and VCSEs. This research focuses solely on Kent, but we believe our recommendations will be useful to any local authority commissioning services or VCSE delivering contracts.

As the cost of living rises, and families struggle to pay their bills, VCSEs will need to step up. But with costs climbing, and emergency covid funding ending, both local authorities and VCSEs have good reason to fear the impact of non-FCR contracts on their ability to meet people's needs.

Risks of non-FCR contracts

It is not straightforward to distinguish between a FCR contract and a non-FCR contract; a complex interplay of factors under the control of both the commissioner and the provider influences whether the contract can be delivered on a FCR basis. Some providers knowingly accept non-FCR contracts when perceived benefits outweigh perceived risks. Others may enter such contracts unknowingly due to inexperience. Sometimes, contracts become non-FCR over time due to unanticipated costs such as inflation.

Not delivering on an FCR basis creates risks for everyone:

- The service may become unsustainable. This would directly impact the people who rely on it, and by extension the provider, the commissioning local authority, and the taxpayer.
- The market is distorted when VCSEs subsidise contracts with other income. Regardless of whether this is to cover core contract delivery or to provide added value, it disguises the true costs of delivering a service at a high-quality.

The central tension of quality, volume, and price

The central tension in commissioning is between quality, volume, and price. Delivering a contract on a FCR basis means making the equation of quality, volume, and price ‘add up’. Flexibility in any of these variables gives the provider space to design a response which meets the contract specification and allows them to achieve FCR. If all three are fixed however, then there is greater onus on the commissioner to make the equation ‘add up’—i.e. to ensure the price is sufficient to achieve the volume and quality required. Outcomes-based contracts offer more flexibility to providers to design a delivery model within budget constraints than output-based contracts—where volume is fixed.

It is this tension which leads to many contracts being agreed on a non-FCR basis. We heard in our interviews that VCSE definitions of ‘quality’ often differ from the methods used to score quality in bids. Talking about this right from the start could create a shared understanding of what ‘quality’ looks like in service delivery, so that scoring criteria can incentivise long-term outcomes. Commissioners should make the most of VCSEs’ knowledge about local needs when deciding on budgets and levels of delivery required.

Recommendations: Improvements within the existing model

KCC’s commissioning practices show examples of good and evolving practice, some of which could set new standards for KCC and other local authorities. This includes active and supportive relationships where commissioners ensure potential providers understand the implications of the budgets they submit. KCC has also been helping VCSEs to engage in commissioning processes more effectively. However, such progressive and proactive commissioning was not consistent across all of KCC’s work. We think improvements within the existing commissioning model could address these inconsistencies, strengthen relationships between KCC and VCSEs, and increase the likelihood of contracts being FCR:

- A common understanding and language around FCR would aid consistency of practice for KCC and VCSEs.

- There should be more consistency on the type and proportion of overheads that can be included in contracts.

There are also opportunities for KCC to support VCSEs, particularly small providers, to better engage with commissioning processes:

- Small providers who are not regularly engaging in commissioning may need more time to submit a high-quality bid. KCC should therefore follow existing standards of good practice about tender submission timelines.

- Small providers may not have the skills or experience to avoid pitfalls associated with achieving FCR. KCC should engage with VCSEs to understand and meet their training and support needs around commissioning.

- Commissioners should be familiar with VCSE budgets, including the overheads and support costs necessary to deliver a quality service, so they can recognise whether VCSE contracts are FCR and so they have a better understanding how VCSE financial models operate. This report includes three VCSE financial case studies to provide a starting point for this (Appendix B).

- A clear and consistent approach to issues around FCR promotes openness and trust between VCSEs and commissioners, particularly in market engagement. Such transparency makes is easier for providers to make good decisions for the benefit of the people they serve.

- Collecting data on key issues associated with FCR could help KCC to understand their scale and impact. For example, KCC could collect data to improve understanding of the frequency and nature of subsidy within VCSE contracts.

Recommendations: Moving towards a new model of shared responsibility

Even after improving existing commissioning practices, the underlying tension of how to achieve shared aims within constrained budgets remains. Both KCC and VCSEs need to be transparent about difficult choices and acknowledge the risks and rewards of different contracting decisions.

A co-production model, while more resource-intensive, could help to mitigate the risk of budgetary pressures leading to poorer-quality services for people in Kent. This would be a fundamental shift from a commissioner-provider power dynamic to an equal partnership, where responses to need are co-produced based on a shared understanding of the cost required to deliver at quality.

Reflections for VCSE providers and market stewardship

For partnerships to succeed, VCSEs must also change:

- Knowingly taking on non-FCR contracts, for mission-driven or competitive reasons, can undercut peers and hide the true costs of delivering a high-quality service from commissioners. In the long run this can create unrealistic expectations as to what can be delivered at what cost.
- Lead providers should consider their responsibility to sub-contractors, for example in building skills and capacities; and KCC should incentivise lead providers to work in this way, for example through its market positioning statements. Responsibility for improving the way the lead provider model works is shared between KCC and lead providers.

Future possibilities

In commissioning this research, KCC showed its commitment to better understanding the question of FCR and the challenges it presents to VCSE partners. KCC clearly recognises the VCSE as valuable partners in achieving the best outcomes for people in Kent. So, whilst all parties recognise there are knotty issues to resolve, we’re confident that both KCC and VCSEs can work together to achieve their shared potential for the people they serve.

We also believe the lessons in this report will be useful to the wider local government sector.

Introduction

Much has been written in the past about good commissioning with the VCSE sector. However, the issue has been deprioritised through Covid-19, and there is relatively little public discourse about commissioning practices generally, let alone the specific issue of FCR. With further budget cuts imminent, a cost of living crisis hitting, and emergency funding ending, the question of FCR remains pressing. This report unpicks the complex issues determining whether FCR is achievable, what the risks of non-FCR are, and highlights current issues faced by KCC and VCSEs.

KCC is forward-thinking compared to peers in grappling with the question of FCR, and there has therefore been real interest in the findings of this research among national interviewees. We found examples of excellent practice within KCC, particularly around contract management relationships between commissioners and providers. However, a lack of consistency in approach makes it difficult for VCSEs to make good decisions in bidding for contracts on a FCR basis.

Both the VCSE and KCC have organisational imperatives for sustainability and cost savings amid increasingly tight budgets, but the objectives of both are ultimately aligned: delivering positive outcomes for people in Kent—and this is something distinctive to VCSE providers. However, through this research, we discovered a lack of shared understanding around FCR. This is leading to misunderstanding, mistrust, and is potentially undermining relationships.

This report includes recommendations for improving commissioning within the existing model, which could support VCSEs to engage effectively with commissioning while also addressing the issue of FCR. Making these adjustments to processes and systems and applying them consistently could foster higher-quality relationships and greater trust between KCC and the VCSE. Many of these adjustments could also benefit providers beyond the VCSE.

With increasing pressure on budgets, KCC is constantly balancing its investment in different needs. It has a legitimate concern that increasing budgets in one area to support FCR could lead to cuts elsewhere. This issue can create an impossible equation, where the quality and volume needed and the price available simply don’t add up. Hiding this tension creates stress and risk for all parties. VCSEs are keen to have a different conversation with KCC about how it recognises quality in contracts through the achievement of long-term outcomes. To do this in the context of constrained budgets requires a more fundamental rethink to the commissioning model.

What might happen if a contract can't be delivered on a FCR basis?

How clear are the terms of FCR contracting?

Finding: KCC stakeholders expect providers to submit FCR bids or take responsibility where they choose to subsidise. Some VCSEs experience challenges with FCR contracting due to lack of experience. There are examples of KCC supporting providers to avoid pitfalls.

KCC stakeholders consistently stated that contracts with the VCSE are—from their perspective—FCR contracts, because providers are expected to bid for services only if they can cover their costs. Some commissioners indicated that providers might intentionally supplement contracted income with other sources to improve their offer above the specification requirements.

Some VCSEs feel confident in their capabilities in assessing whether a contract can be delivered on a FCR basis. Others, however, mentioned hidden or unpredictable costs, or referred to other VCSEs who lacked the necessary skills or experience to account fully for costs. As a result, some entered contracts naively without accurately or fully assessing their ability to achieve FCR.

'I think smaller organisations struggle more. Bigger organisations have been "bitten" in the past, so they will have learned and won't make the mistake again.'

KCC stakeholder

We also heard examples of commissioners taking a very proactive approach in supporting VCSEs to assess whether budgets were realistic.

What are the risks of different scenarios relating to FCR?

Finding: VCSEs can end up delivering non-FCR contracts for several reasons. Frequently, non-FCR contracting poses a risk to the provider and to KCC.

To understand the potential outcomes and risks of these dynamics, it is useful to break down the scenarios where VCSEs enter contracts without a clear, shared understanding of FCR. The table below outlines these scenarios and their potential impacts.

Scenario	Potential impact
1. Contract delivered on a FCR basis.	Mutually beneficial.
2. Despite careful assessment, unanticipated costs undermine FCR.	Risks to org and service.
3. Provider enters contract on non-FCR basis due to inexperience.	Risks to org and service.
4. Provider chooses not to bid because can't achieve FCR.	Loss of expertise / income.
5. **Core** contract specification **can** be delivered within budget and provider provides **added value** through other income sources.	Added value but distorts market.
6. **Core** contract specification **cannot** be delivered within budget and provider opts to **subsidise** delivery through other income sources.	May not align with KCC policy. Unpopular with other funders.
7. Budget template does not allow for accurate representation of overheads (nature or level) but provider decides to 'just make it work'.	Ongoing stress for VCSE. KCC doesn't see true costs.
8. Budget doesn't cover full costs, but provider decides the risks of not getting the contract outweigh the risks of non-FCR delivery.	Risks to org and service.

When the potential impact is *'Risk to org and service'*, there is a risk to the sustainability of the provider; to people in Kent who rely on that service; and by extension, to KCC.

Causes of these scenarios

Finding: It's not straightforward to distinguish between a FCR and a non-FCR contract. Rather, a complex interplay of factors controlled by both the commissioner and the provider influences this.

Whether or not a contract is FCR is not simply a question of whether the commissioner has set an appropriate price, or whether the provider has budgeted appropriately. It is a complex interplay of factors within the control of both parties.

Below we have identified six key issues which influence whether a contract can be delivered on a FCR basis. These issues will be discussed in greater detail through the report:

1. A mismatch between the funding available for the contract and the contract specification.

2. A mismatch between the funding available and the way in which a VCSE provider wishes to deliver the service, in order to align with its mission and achieve long-term change.
3. A lack of shared understanding about FCR and the risks of contracts that are not FCR. This makes it difficult to have transparent conversations or plan to manage associated risks.
4. Knowledge gaps and inexperience of VCSE bidders, and a lack of support to put together budgets and assess costs.
5. Systems, processes, and budget templates which unwittingly make it more difficult for VCSE bidders to engage.
6. Insight gaps from commissioners about the nature and level of needs, and the costs of delivering a response which will achieve long-term outcomes.

Who is at risk where contracts are not delivered on a FCR basis?

Finding: There are risks to all parties if contracts cannot be delivered on a FCR basis. If the provider struggles, the commissioner will not achieve their desired outcomes.

Risks to VCSEs

Non-FCR contracts pose significant risks for the culture and the financial sustainability of VCSEs. It is far from guaranteed that other fundraised income will be available to cover indirect costs, particularly for VCSEs that receive a high proportion of funding from contracts.

Within VCSEs, the impact of non-FCR contracts on staff poses significant risks to service delivery and financial sustainability. When employment contracts are unstable, VCSEs report that they are in competition for staff with public sector providers, who can offer longer-term, more stable contracts. When there is high staff turnover, services are disrupted, trusted relationships with service users are lost, and organisations bear additional costs for re-recruitment.

Risks to the VCSE sector

Subsidy hides the true cost of services and makes it difficult for VCSEs to argue for an uplift in cost, either within the same contract period or for subsequent contracts.

Some VCSEs perceive that the move towards commissioning rather than grant-funding has negatively contributed to a more competitive and less collaborative VCSE sector, with larger providers taking a higher share of contracts. Some believe this approach can push out smaller organisations with more niche, specialist skills and experience.

Risks to quality of services

If services cannot be delivered on a FCR basis at quality, it is likely that high-quality VCSE providers will decline to bid. That leaves the market reliant on poorer-quality providers, delivering a poorer-quality service for Kent residents.

If VCSE providers feel they cannot be transparent about changes to costs over time, and KCC is not made aware of this promptly, there is a risk that the quality and volume of services will be adversely affected.

Risks to relationships between VCSEs and KCC

Where VCSEs perceive that contracts are undervalued, or are delivering contracts which cause financial instability, there is the potential for communication to breakdown between VCSEs and KCC. As one national stakeholder noted:

'It's also not benefitting the relationship where the contract is undervalued… that sets the tone for the relationship. If the service feels that there are emerging needs not being met that need more funding, the communication might break down.'

Risks to KCC

Ultimately, KCC holds the responsibility and risk for the delivery of services to people in Kent. Therefore, the risks of the current approach to the sustainability of individual providers and the VCSE sector create risks for KCC as to who will deliver services if these organisations fail. There is also a risk to KCC if the current approach threatens the quality of delivery and outcomes for people in Kent, as KCC is accountable to voters in the local community.

Has Covid-19 exacerbated risks?

Finding: With rapid innovation, emergency funding, and flexibility from commissioners, the VCSE sector weathered the pandemic better than some predicted. But Covid-19 saw needs rising, and with a cost of living crisis hitting at a time when emergency funding is ending, KCC and the VCSE are concerned about the coming months.

Needs for charitable services have grown since the pandemic hit, driven by a range of factors, including closure of traditional support channels. The pandemic also created or revealed new needs, with many individuals relying on charities for the first time.

Overall, VCSEs praised the Covid-19 support they received from KCC regarding emergency funding and flexible attitudes from commissioners. KCC stakeholders similarly praised the responsiveness and innovation of VCSE providers as they pivoted services.

However, some VCSEs reported a lack of understanding from KCC about the challenges of operating under increased demand and pressure. One VCSE felt that commissioners should have taken on more of the risk involved with this increased demand.

Although lockdown pressures have now eased, inflation and the cost of living crisis are pressing issues. This will exacerbate needs in communities served by VCSEs and KCC-commissioned services. It will also affect VCSEs as employers whose costs are rising, with employees whose wages are not keeping pace with price increases.

Many VCSEs expressed concern about the future sustainability of their services with emergency funding ending, particularly as much emergency funding has short-term spending deadlines. VCSEs need clarity regarding future funding and how prices will be determined.

KCC stakeholders are concerned by the overall increase in pressure and demand on the voluntary sector at a time when income streams have been severely disrupted. This concern for the next six to twelve months was echoed in all our conversations with peer authorities (Appendix C).

'I feel that we've managed to weather the storm with sector... but the point we are at now will be telling, as some of our interventions and government interventions are coming to an end or have already ended and so as we start to move into the recovery period, people will start to feel the pinch [of issues such as inflation] which can have serious impact on the fundraising capability of the sector and could cause some real issues going forward.'

KCC stakeholder

KCC’s practice in VCSE commissioning

How well is KCC’s VCSE commissioning working overall?

Finding: Despite some inconsistencies, KCC’s commissioning practices with the VCSE show examples of both good and evolving practice, some of which could help to set new standards for itself, and for peer organisations.

VCSEs reported that KCC has a high standard of contract management during delivery. VCSEs emphasised the need for commissioning relationships based on honesty and flexibility in the face of changing circumstances and feel that KCC delivers this in some cases, albeit inconsistently. Some had positive experiences of building these relationships, and found commissioners to be responsive and engaged:

‘We have a brilliant commissioner. She is the best commissioner I've ever worked with in my life. She's very, very collaborative. She doesn't play out a power imbalance. She doesn't think she knows it all. ... And that's really valuable. She does listen if you say, “Actually, that's not workable”.’

VSCE stakeholder

On the other hand, some VCSEs reported mixed or negative experiences:

‘I've been fortunate that with the number of the commissioners I've worked with, we've talked about a collaborative commissioning model and playing to strengths and recognising success, and we've had some really good experiences. But there are some much more punitive contract managers and commissioners who take a very different approach to managing the work that's undertaken.’

VCSE provider

Despite these negative experiences, some VCSEs recognised the constraints on commissioners, which limit their freedom to adapt in the ways VCSEs might suggest:

‘[Commissioner] is fantastic. But I feel like she is stretched.’

VCSE provider

'[Commissioners] are so open to criticism that they have to be quite clinical in how they approach commissioning in most instances. The very nature of that can be quite problematic in terms of relationship building [with VCSEs].'

VCSE provider

This awareness of commissioner constraints was not shared by all VCSEs, which may exacerbate tensions when they arise.

How has KCC worked to include the VCSE in commissioning?

Finding: KCC has been working to support VCSEs to engage in commissioning. We found pockets of progressive and proactive commissioning, but this was not consistent.

KCC has been working consciously to improve the consistency and quality of its commissioning relationships with the VCSE. In particular, KCC has been supporting the transition of many VCSEs from grant-funding to commissioned contracts. This support has included:

- Grant scheme investment in building the capacity of VCSEs.
- Individual commissioners helping potential providers to understand budgets and outcomes reporting.
- Pre-market engagement about contract specifications.
- Public advertising of contracts on a central portal with adequate response time, and promotion through networks.
- Simplifying application processes.
- Encouraging providers to bid in consortia.

While some VCSEs found these practices useful, we heard that more advanced supportive practices—such as commissioners working with providers to understand budgets and develop accurate costings in bids—are the exception rather than the rule.

We also heard that some of the more standard practices, such as giving adequate time for VCSEs to mobilise and respond, are not always in place. This is a barrier for VCSEs seeking to participate in commissioning opportunities.

What is the value of the VCSE in commissioning?

Finding: Previous research into VCSE commissioning has identified the unique value of the sector with regards to both local services and local communities. This theme was echoed by KCC stakeholders and in our document review.

KCC sees in the VCSE as a partner in theory, even if this attitude is not always applied consistently. This is reflected in its decision to commission this research. According to sources including KCC's Civil Society Strategy, VCSEs have unique value for KCC because:

1. They work in a preventative way, to 'shore up' individuals before they need to access statutory services.
2. They hold existing relationships of trust with communities, including those who may be frequently excluded from mainstream services, as well as with other stakeholders such as health professionals.
3. They have research and evidence assets, including a deep understanding of the needs and experiences of communities.
4. They bring flexibility and innovation, responding to changing situations effectively because of minimal bureaucracy and an understanding of communities' changing needs.
5. Local VCSEs (like local SMEs) support the local economy by keeping supply chains in local areas. Conversely, national VCSEs can take the supply chain out of the local area.[1]
6. They bring additional resources to ensure public service delivery is a success, including expertise, relationships, and effective referral pathways. This also includes volunteers who—while not free to recruit and manage safely and effectively—can reduce costs. This can also include additional financial resources, such as fundraised income, and it is this final added value which makes the question of FCR a tricky one.

Aside from these practical factors, perhaps the most distinctive role the VCSE can play goes beyond contract delivery, to influencing the design of public services. As NPC wrote in *Times of Change:*

[1] These factors are drawn from primary research of this project, as well as Frank Villeneuve-Smith and Julian Blake, *The art of the possible in public procurement* (London: HCT Group, 2016) and NPC, *Unlocking Potential, Realising the role of local charities in public service*, 2016.

'Where charities are active in commissioning, they can act as a check on how that market might otherwise operate. Even if unsuccessful in securing the contract, their presence in the market, and the service quality they offer, can encourage commissioners to expect more of other providers and force private providers to up their game. At the very least, they can act as a bulwark against a 'race to the bottom' on costs and quality.'[2]

How does KCC engage the VCSE market?

Finding: KCC tries to engage the VCSE market, but its processes are inconsistent and inaccessible to some VCSEs. Some VCSEs perceive that there is an 'inner circle' of trusted organisations which are regularly consulted above others, which may undermine trust.

KCC makes efforts to engage the VCSE market, although with some inconsistencies of approach and practice. KCC hosts VCSE sector engagement events and runs a marketplace forum for VCSEs to engage with each other. It has established its VCSE Steering Group and Partnership Board to create more channels for communication between KCC and the sector. It is also currently funding a review of the Steering Group regarding wider engagement channels, which are recognised as a challenge by both KCC and the group.

How accessible do VCSEs find market engagement activities?

Some VCSEs find market engagement events inaccessible, and smaller organisations without well-established relationships with KCC can find it difficult to influence commissioning during this process. In some cases, specific organisations may be invited to consult on contract design, but this is not always made explicit to the rest of the sector and results in a sense of an 'inner circle'. KCC sometimes advertises events in a small window with limited notice, and events are often hosted in a corporate environment, which again can make events feel inaccessible to smaller charities. The time and resource taken to attend multiple engagement events, particularly where organisations are unsure if they will be awarded a contract, can also be difficult to balance.

'I absolutely get we're in an environment where funding is only going to get tighter and there's going to be less of it, but actually that should then mean that there is more conversation because we need to be mindful of how we spend a little resource better and more tightly.'

VCSE provider

[2] NPC, *Times of change: Briefing on public sector commissioning*, 2015.

KCC has taken steps to improve the accessibility of these processes, for example by testing longer notice periods for advertising events, but without seeing a substantial increase in VCSE engagement.

One VCSE noted that part of this inconsistency is due to VCSEs' varying ability and capacity to build strong enough relationships to have frank conversations with KCC:

'It's not a level playing field, there are stronger players...who take a more robust approach with KCC about FCR, whereas other charities may not have the confidence or knowledge to take that approach. There is always a human element to procurement, so the ability to build and deepen relationships with staff within KCC inevitably helps.'

VSCE provider

The net effect of this inconsistency in KCC's approach, and VCSE reception of engagement activities, is that it contributes to a perception of an 'inner circle', which ultimately restricts the market. By ensuring engagement is accessible to a wide proportion of the VCSE sector, KCC could increase the breadth of engagement and quality of input it receives, as well as increasing trust and supporting productive relationships.

While wide engagement allows for fairness and transparency, it can be resource intensive. Narrower engagement does allow for an efficient way to hear from the most interested parties, but risks excluding important perspectives. Whatever approach is taken, the approach and rationale needs to be communicated to potential providers.

Supporting the VCSE while treating all providers equally

Finding: It can feel difficult to strike the balance between supporting the VCSE without unfairly disadvantaging other providers, but it is legitimate to set scoring criteria which allows socially motivated providers to play to their strengths.

VCSEs have become an increasingly important partner in the delivery of public services. Commissioners need to balance a desire to recognise and support the value of VCSEs without contravening the legal need to show equal treatment; non-discrimination; transparency; and proportionality. Procurement teams tend to be risk-averse, favouring competitive approaches to manage the risk of legal challenge.

However, experts argue that the Public Contracts Regulations of 2015 were designed to *'make your freedoms clear, promoting good commissioning and encouraging innovation. The regulators* *want you to use these freedoms.'*[3] The current Green Paper also signals an intention to continue embedding social value into procurement. The key to supporting—or at least ensuring the inclusion of—social sector providers in the commissioning process is to define:

'A clear specification that values, for example, evidence of strong local knowledge and connections; or wider commitments beyond the contract to the community… [so that it is] technically open to any potential supplier. [You thereby create] a procurement process and award criteria that allow social sector and local organisations to play to their strengths, showcasing the wider impacts that they create in the context of a specific contract. This ability to create social value is deservedly a source of competitive advantage.'[4]

Is a standard procurement exercise the only way?

Finding: There are alternatives to standard procurement exercises, and VCSEs are interested to work with KCC to design new solutions.

VCSEs feel that commissioners could make more of these freedoms provided by the legislation:

'Kent does some good market engagement; it is open and consultative. The procurement Kent does, it does not do badly. But it is quite constrained by the procurement process. It could be open to conversations about how to do things without the whole public procurement process… But Kent's commissioning is not set up that way—it just thinks of its role as outsourcing through commissioning of services. It's constrained by this thinking and it's not innovative enough in thinking about solving the issues that it faces.'

VCSE provider

Alternatives to standard procurement may feel risky, untested, and require investment of time by over-stretched commissioning teams. However, there is growing recognition that with reduced budgets, innovative commissioning to reach shared solutions is the only route to success.

[3] Frank Villeneuve-Smith and Julian Blake, *The art of the possible in public procurement*, (London: HCT Group, 2016).

[4] Ibid.

Alternatives to a standard procurement exercise[5]

Light-touch regime: Governs social, health, and education services. Permits the development of entirely bespoke processes so that commissioners can be confident of procuring something which meets communities' needs. This is aligned with the principle of proportionality.

'As long as the principles of transparency and equal treatment are adhered to, you can design pretty much any procurement process you like. If you think elements of competitive dialogue will give you a better outcome—include them. If you want a pre-qualification stage with a bespoke selection process and criteria—go right ahead. If you want bits of the competitive procedure with negotiation—it's up to you.'

Reserved contracts: Available exclusively for social sector organisations if the contract is for a specific type of service and there is a clear and articulated rationale as to why a social sector organisation is objectively the best type of service provider. Reserved contracts are essentially a 'shield' which can be in place for three years.

Innovation partnerships: Designed to enable commissioning in situations where the answer is not yet known**.** As you cannot know the final specification before you begin, you are procuring the process that leads to the specification and its subsequent delivery—and the partner(s) you will want to go on that journey with.

Many VCSEs expressed an interest in working with KCC to co-design services.

'The time is now to shift this to become true partners and true collaborators. A change of attitude might help overcome challenges of growing demand and diminishing budgets. That comes down to stepping out of the treadmill thinking of needing to run a procurement exercise every time you need to secure a service. Have conversations first and explore other ways to do it. The time is now to be brave. Change the dynamic so it's not transactional.'

VCSE provider

[5] This was not the focus of our research. This information may be incomplete and subject to change with the upcoming Green Paper. This information is drawn from Frank Villeneuve-Smith and Julian Blake, *The art of the possible in public procurement*, (London: HCT Group, 2016).

Key issues relating to contract pricing and FCR

The initial focus in discussions of FCR is often on overhead costs, and the overhead allocation that providers are permitted, or encouraged, to submit. However, this research raised an equally important question of whether budgets are sufficient to deliver services at quality. This requires us to look at the assumptions, expectations, and practices of KCC and VCSEs in setting budgets.

KCC's budgeting practices

Finding: Commissioning teams have limited freedom within headline budgets. There does not seem to be consistent practice in terms of contract design and pricing across KCC, although there may be consistency within specific teams.

Headline budgets

The VCSE is interested in learning how KCC sets budgets. This would help VCSEs to understand where there may be flexibility, and what assumptions are made about the level and nature of need. The overall budget available to deliver a service clearly has a bearing on whether it can be delivered on a FCR basis.

As with all local authorities, headline budgets in Kent are set by elected members in response to national priorities; democratic responsibility to voters; and statutory responsibilities. Statutory services, many of which are highly regulated, make up most budgetary commitments, although Kent has worked hard to preserve non-statutory spending. Commissioners are therefore operating within clear boundaries when setting individual contract budgets.

How consistent are KCC processes for specific contract budgets and pricing?

When allocating budgets for different services, KCC considers several factors, including:

- Expected delivery and overhead costs.
- Length of contract.
- Proportionate risk and how this will be spread across any partners in a delivery chain model.

For some commissioning areas, the annual amount devised through the budget allocation process is then split geographically based on perceived needs—for example, based on locality deprivation levels. An example of this in practice is the Live Well Kent contract. One KCC stakeholder described flexibility in budget allocation after contract awards, and gave an example of two organisations pooling their funds and assigning this based on where they saw the greatest needs.

'If the need changes, we are happy to be flexible and move money around to meet needs.'

KCC stakeholder

We heard from both KCC and VCSEs that there is not always an established methodology or consistent practice in terms of contract design and pricing across KCC, although there may be consistency within specific teams. Where teams or individuals use a consistent methodology, this does not seem to be clearly communicated either to VCSEs or other commissioners.

Different teams take different approaches to contract management; information-sharing; and engagement with providers about budgets. Many VCSEs do not understand how budgets are set, although some VCSEs acknowledge constraints on commissioners' budgetary freedom.

Additional funds awarded post-contract

Finding: In some instances, KCC has increased contract funds after appointing a provider. This has caused a breach of trust among providers who realised the contract could not be delivered on a FCR basis and opted not to bid.

We heard from KCC that there are conversations after contract awards about other money that can be accessed to 'top-up' contracts, for example by providers working collaboratively with the CCG or other VCSEs. Commissioners also have conversations with existing providers about opportunities such as match funding when looking to decommission services, to aid sustainability.

However, some VCSEs mentioned experiences where they had opted not to bid for contracts after calculating they could not be delivered on a FCR basis. The successful provider had bid based on delivering the service with funds available, and after the contract was awarded explained that the service couldn't be delivered in the original budget and negotiated additional funds. Practices such as this unintentionally incentivise irresponsible behaviour and penalise organisations who give careful thought to questions of FCR as they scrutinise the specification.

Costs changing over time

Finding: There is a likelihood of contracts diverging increasingly from the FCR-basis over time. This presents a risk if there is no 'safety valve' to recalibrate contracts.

Some VCSEs noted that costs to deliver a service at a consistent level of quality can change over the period of a contract. A contract might therefore appear to be FCR, but the real costs of delivering it can diverge from funds available over time. Factors influencing this might include:

- Inflation and increases in energy and fuel costs, compounded by the cost of living crisis, which are of particular concern to smaller organisations.
- The impact of Covid-19 and the EU transition, which have put pressure on building supplies and maintenance.
- Increases in minimum wage, which put pressure on VCSE budgets, as staff wages need to be increased across the board.
- Recruitment and retention costs for staff, necessary for providing a good quality service.
- The costs of senior management time in attending regular meetings, if this expectation is not made explicit up front.

Some interviewees felt these costs were difficult to predict and calculate in advance, while others felt the issue was more around the naivety of providers not factoring in these assumptions. Some VCSEs felt that private sector or larger national providers are better placed to absorb these unanticipated costs. While this should not be the expectation of any provider, the risks here are greater for small providers. There is also a potential risk for smaller VCSEs where overheads may grow over time when setting up dedicated infrastructure, such as new job roles or IT infrastructure, to service a contract's needs. This can pose issues towards the end of contracts, where these VCSEs may not have an exit strategy for continuing or closing down this infrastructure.

It appears that these factors are not routinely highlighted in KCC guidance to bidders. Therefore, it is the experience of the bidding organisation that determines whether these are factored into budgets. KCC could take a proactive role in telling providers which factors they should include in their budgets, to prevent avoidable challenges and protect both sides. We did not hear of any expectation from KCC commissioners to offer inflationary uplifts, or mid-contract reviews of costs. While recognising KCC's need to manage its own costs, this lack of 'safety valve' could bring risk to all parties with the level of inflation experienced and anticipated.

Perceptions that the VCSE is a cheaper option

Finding: Perceptions that VCSE providers might be cheaper are rarely accurate.

Several KCC commissioners and national experts felt that in theory the VCSE might be seen as a cheaper option compared to other providers—although few respondents held that view themselves. There are several ideas about VCSEs that feed into this perception:

- That VCSE resources can subsidise core contract delivery. This situation should not be happening, and is not part of KCC's approach.
- That VCSEs can fund overheads (support costs) through other income sources. This seems to be happening in some areas.
- That VCSEs can deliver at a lower cost because they are non-profit and happy to operate 'on a shoestring'.

This final point does not reflect the reality of VCSE budgeting and overheads. For example, a VCSE may deliver some work through volunteers, and its governance may be supported by unpaid trustees. This can lead to a commissioner misperception that unpaid support is 'free'. In reality, volunteer management, training, supervision, and safeguarding take time and resources, as does supporting the effective decision-making of an unpaid board.

Subsidy and added value

Finding: Subsidy is not always planned, and it's not always visible to the commissioner. Subsidy always risks distorting the market by reducing the price a commissioner will see as necessary to the achievement of a quality outcome.

VCSEs' ability to leverage additional resources is acknowledged by KCC as an asset and a competitive advantage. These assets might be non-financial and provide added value above the core contract specification, such as existing relationships of trust with service users, or complimentary services funded through other means. This is unlikely to reduce prices for core contract delivery, but it might make the VCSE provider more likely to achieve the long-term outcomes KCC ultimately wants to commission.

Sometimes, contracts are subsidised from other sources of charitable income, such as traded income, grants, or other fundraising. As noted in the previous section, we did not hear examples of VCSEs supplementing funds to cover core contract delivery in KCC, though in some cases VCSEs might supplement overheads or additional delivery beyond the specification. This subsidy might be:

- **Planned,** if the charity knows in advance it cannot cover costs with available funds.
- **Unplanned,** if unanticipated costs occur, or overall costs rise through the contact.
- **Visible to the commissioner,** where it is outlined in tender submission documents.
- **Hidden from the commissioner,** for example, where a commissioner has stated they won't cover certain overheads.

Most VCSEs said they do not feel pressured to leverage additional funding, although there were examples where this was an explicit or implicit requirement. It is not always clear to VCSEs whether this factored into award decisions; one commissioner stated that match funding can be evaluated as part of a tender. One VCSE explained that while there is no expectation to leverage in funding, this can help provide a more holistic service, which appeals to commissioners:

'Being a mission-driven organisation, we will go into tender and say, "Here's all the other things we do that will wrap around this". So, we do leverage in because we know that a holistic approach is the most effective. We've never been made to feel like we have to top that funding on.'

VCSE provider

Commissioners told us that where the success of a service rests on fundraising that is not yet secured, this needs to be made clear in the tender submission. In one example where this was not made clear, contract resource had to be subsequently redirected from service delivery to fundraising.

In the case of social care, some private providers supplement their contracts by charging for services. One VCSE felt there is an assumption that VCSEs will supplement their income on a similar basis. They felt it would be useful to know what specific expectations there are around costs gathered from additional funds, to help create an even playing field.

If subsidy allows VCSEs to offer the same service to different people, it is easier to distinguish between the value 'purchased' by the commissioner, and the additional value provided by the subsidy. However, if subsidy increases quality or builds 'wraparound' services, it is more difficult to make the distinction, and even where subsidy is explicit, a commissioner may not understand the true costs of delivering the service at quality. When VCSEs engage in this approach, they are putting the sustainability of the sector, individual services, and people supported by them at risk.

Acknowledging a central tension: Quality, volume, and price

Volume and price

Finding: Outcomes-based contracts offer more flexibility to design a delivery model within budget constraints, making FCR more achievable. Output-based contracts have less flexibility, and there is greater onus on the commissioner to set an appropriate price.

In some contracts, a fixed level of delivery is required for a fixed price. These contracts are monitored in terms of outputs, and are often associated with the delivery of statutory services, where provision is needed for a known number of people meeting the threshold criteria of need.

The realism of delivering these contracts on a FCR basis rests on the quality of insight on levels of need when commissioners are setting budgets. For statutory services, the number of people meeting a threshold of needs is often quite transparent, and although VCSEs might want to make the service available to a wider group of people, the ‘unit cost’ available should be transparent. In these contracts there is fairly good information upfront to help providers decide if budgets stack up, although a provider may decide it cannot provide the desired quality of service at the price available. If the provider chooses to proceed, there is little room to adjust delivery or to innovate to achieve the outcomes in a different way.

For contracts managed on an output basis, where an understanding of need is poor, or where budget has not been based on an accurate understanding of need, it may be even more challenging for any provider to deliver on a FCR basis.

Other contracts are managed based on outcomes—the changes commissioners want to see in those using the service. Where this is not tied to delivery targets, providers have space to develop a model within a fixed budget envelope. This can be helpful in preventing a ‘race to the bottom’ in terms of pricing:

‘Then you can go in and realistically say what you can do for that money.’

VCSE provider

The role of insight in setting budgets

Finding: KCC does not seem to be making the best use of information about need in budget-setting, and VCSE knowledge is underused. Where there is unacknowledged tension between budget and the level of delivery required, there is a risk passed on to the provider market.

Ideally, budgets would be set using the best available information about the level and nature of need, and the cost of delivering services at quality. Our research indicates that VCSE insight on community needs is sometimes, but not routinely, influencing commissioner budget allocation.

Stakeholders did not report any effective mechanism by which elected officials can hear reliable and consistent insight from the voluntary sector about tensions in strategic-level budgets. However, KCC is aware of this issue and is currently looking to improve these engagement practices.

This has critical implications for service design and delivery. Where there is inadequate funding to deliver a core quality service, but this fact is ignored or poorly understood, then the risks of contract failure and poor service delivery are passed on to VCSE (or other) providers. If VCSE insight is considered during budget-setting, there may be an opportunity to rethink how that budget is used in fundamental ways.

Scoring criteria: Cost and quality

Finding: VCSEs feel that many contracts are not priced to allow FCR on a high-quality service. Many expressed wider concerns about the way quality is assessed by KCC.

We heard from commissioners and providers that there are two main factors under consideration when evaluating tenders: price and quality.

KCC uses a calculation to provide a value for money score. This compares the proposed cost, reach, and quality of competing bids. In theory, this allows commissioners to balance the need to spend within very tight budgets while disincentivising awards to extremely low bids that may not provide quality services. For example, we heard from one commissioner that any tender submitted that has a cost of less than 20% of the average costs proposed by other bidders will be excluded as unsustainable. Quality scoring is also used to reward added value beyond the scope of the specification.

Many VCSEs we spoke to do not feel that KCC contracts are priced to allow FCR on a high-quality service, and one expressed the feeling that this is especially true for non-statutory services.

The question of cost and quality occurs at two different stages of the commissioning process.

The first occurs in the **setting of the maximum contract price**, which is often determined at a strategic level and not by the individual commissioner. If the total budget envelope is too small to support a provider to deliver on a FCR basis, then experienced, mission-driven providers may decide not to respond to a tender opportunity. Over time this may exclude high-quality bidders from the market, and in turn affect the quality of services for people living in Kent.

The second occurs in the **scoring** of bids received. This splits further into two issues:

1. The **relative weight** allocated to scoring of cost versus quality. VCSEs find this information very transparent in tender documentation, and although there were discussions about the correct weighting, this does not seem to be a major point of controversy. Indeed, commissioners explained that quality is evaluated before pricing.

2. The **way quality is assessed**, and whether commissioners are recognising and rewarding the ability to deliver high-quality services, rather than the ability to submit high-quality bids.

The question of **the way quality is assessed** was one of the most pressing and often mentioned themes in our conversations with VCSE providers. This is an issue of FCR insofar as it's a question of whether the contract price reflects the true costs of achieving the necessary value. It is also a much wider commissioning issue: a question of whether there is alignment between commissioner and provider over what is purchased and what is delivered, and who takes on what risk and responsibility where these do not match up.

Different interpretations of quality and value

Finding: VCSEs are concerned that quality scoring does not align with the achievement of long-term outcomes. Scoring for long-term outcomes could play more to VCSE strengths. More importantly, it should lead to higher-quality services for people in Kent.

Our research indicates that VCSEs offer value by delivering services in a way which achieves lasting outcomes. While VCSEs are already successful in commissioning, many feel that KCC's commissioning processes do not fully reward the value they deliver—and which KCC needs for the contracts to be a success in the long-term.

This is a risk for VCSEs in that they appear less well—or less uniquely—positioned to be successful in a tendering process. But it’s also a risk for KCC, as it could procure a service which meets contract specification but does not achieve long-term benefits for people in Kent.

Many VCSEs feel that while individual commissioners understand the value of the VCSE, this is not necessarily reflected in current commissioning scoring criteria and processes.

‘I think funding, particularly now, is always going to lead decisions. But I do think if you've got a strong commissioning team, they do understand the quality aspect as well.’

VCSE provider

VCSEs expressed two concerns with how quality scores are currently calculated:

- **They can reward the quality of bid-writing rather than the quality of potential delivery.** This could favour organisations who are experienced in bidding, even if they do not have a track record of impact.
- **They can reward activity over outcomes**, by favouring providers who promise to deliver activity at certain levels over those who recognise that achieving outcomes will need a different type of activity, or a greater depth of relationship.

These possible issues mean KCC may have a false understanding of the costs to deliver services at quality, and may set budgets which do not support FCR at the quality needed to achieve lasting outcomes. Some KCC stakeholders also noted concerns around a *‘one size fits all’* approach to contracting, as simplistic processes may not allow for an accurate reflection of the quality and value VCSEs can bring. VCSEs were eager for KCC to look for other ways to evidence quality, such as the quality of relationships, or a track record of achieving long-term outcomes in delivering similar work.

This is not about recognising and rewarding VCSEs. This is about recognising and rewarding the aspects of contract delivery which drive a quality service and the achievement of outcomes for people in Kent. VCSEs feel that their experience of success in achieving outcomes, and the fact that they are driven by mission rather than profit, means they are best placed to see where changes need to be made to reward this long-term, outcomes-driven perspective.

Reasons KCC and the VCSE might think differently about quality and value

Finding: The mismatch between VCSE definitions of quality and KCC scoring of quality may be a genuine difference, driven by KCC's budget pressures and a possible lack of alignment between KCC's vision and VCSE missions. Nonetheless, opening a dialogue about this could bring the definitions closer together and guard against unintended short-term incentives in contract specifications.

This points to a deeper question—whether there is alignment between what commissioners choose to buy, and what value-driven VCSEs are willing to deliver. Commissioners might:

- Unintentionally set a specification which incentivises a short-term approach over an approach which achieves long-term change.
- Intentionally commission a service which they know is not 'gold standard' due to budget constraints and the need to balance competing priorities. We heard some KCC stakeholders expressing this view. This may also occur when KCC and the VCSE do not agree on priority services, or parts of services, that need commissioning.

In the former situation, market engagement from the VCSE can help KCC set a specification which appropriately rewards quality and the capabilities of organisations which can deliver long-term change. In the latter situation, VCSEs need to influence commissioners to understand that short-term savings will lead to costs in the longer-term. Ultimately, KCC shares the ambition of achieving long-term benefit for people of Kent and there is mutual benefit working together to think differently about using limited resources to achieve long-term change.

Nonetheless, there may still be situations where KCC's definition of quality—and therefore, value—genuinely diverges from that of the VCSE. In those situations, the VCSE needs to assess whether it can be successful, and is happy to deliver a service, where the specification does not fully align with its definition of quality.

Reflections for VCSE providers and market stewardship

VCSEs choosing to enter non-FCR contracts

Finding: VCSEs may knowingly take on non-FCR contracts for moral or competitive reasons. This may offer competitive advantage to the organisation and value to commissioners, but can undercut peers and hide the true costs of delivering a high-quality service. The VCSE sector should work towards a more collaborative approach. It should avoid distorting the market by undercutting the price required to deliver at quality, and be brave in engaging with commissioners on how to improve commissioning practices.

In some circumstances, VCSEs knowingly enter into non-FCR contracts, while the local authority perceives the contract to be FCR. There are several reasons for this choice.

Firstly, VCSEs may position themselves as a loss leader, for example if the Board and senior management want to expand into a new market. This can be an effective tactic where the VCSE wants to grow strategically or be seen as a key player in a particular service area. It can also help organisations to integrate certain services and drive down costs; this can be accomplished by sharing the non-FCR costs across several contracts.

Secondly, VCSEs are mission-driven, and can feel compelled to take on work that they believe is directly relevant to their strategy and will have a strong impact on beneficiaries. In some cases, VCSEs believe they are the best—or only—organisation that can deliver that service effectively, particularly if they are already delivering similar work and understand existing needs, and if they know service users will come to them anyway due to their long-standing, trusted reputation. This leads some small charities to feel they must bid for a contract even if they know it will be non-FCR, because effectively they will end up delivering the service regardless:

‘Sometimes the contract goes to a big new provider and then they don't get the service, and then the people come back so they end up delivering the service anyway because service users vote with their feet. The services are based on trust and local relationships and if it gets TUPE-d to a provider that doesn't understand the local context, of course they'll go with the charity they trust.’

A market stewardship role

As mission driven organisations, VCSEs should not be pursuing growth for its own sake, but only when aligned with mission. And whatever the rational or moral drivers, when VCSEs knowingly take on contracts below the true costs of delivering them, there are several impacts:

- They risk their own financial sustainability, and thereby the quality and continuity of services to people in Kent.
- They may undercut other VCSEs.
- They may hide the true cost of delivering the service—an important piece of information for commissioners wanting to make good decisions.
- They may distort the market by establishing that reduced price as the benchmark for future services.
- They lose the opportunity to influence commissioners—individually or collectively—about what a high-quality service should look like and what it costs, thus preventing the 'race to the bottom'.

VCSEs should work collectively to push back against commissioners where commissioning practices undermine the quality of services or the sustainability of organisations. This is linked to a collective responsibility for the sector in ensuring good practices in areas such as board management or financial risk are applied consistently.

Supply chain models

Finding: The experience of the lead provider model is mixed and there are risks to the existence of niche providers where it is not working well. Responsibility for improving the model is shared. Lead providers should consider their responsibility to providers in the supply chain and consider where they should take on the responsibilities of the commissioner, for example to build the supply chain's skills and capacities. KCC should develop an approach to market stewardship for the lead provider model.

A supply chain model can support access to contract income for organisations which lack the capacity to bid alone, and reduce duplication of time and skills needed to bid. It can also lead to financial savings for KCC. Among VCSEs, the supply chain model has delivered some examples of success. Live Well Kent was cited by numerous providers as an example of this model working well, with a lead provider delivering across a range of contracts at good value.

We also heard from some smaller, subcontracted organisations that they value the lead provider model for various reasons. One organisation felt that contracting with their lead provider as opposed to KCC made the commissioning process less competitive and *‘more of a conversation’*, with more frequent and clearer communication. Another organisation said their lead provider is very supportive and provides training in areas such a bid-writing and fundraising. The VCSE also appreciated that this lead organisation had worked to gain an understanding of their frontline delivery, for example by spending a day visiting their site and seeing their delivery in-action.

At the same time, the model raises some tensions, with some smaller VCSEs experiencing challenges in their relationships with lead providers. We heard examples of difficult and arguably disproportionate burdens of contract compliance, including examples where subcontractors chose to drop out of supply chains where these were too onerous.

The model may be more advantageous to KCC financially, but one VCSE stakeholder noted that the move to supply chain models now allows the smaller organisations *‘pieces of funding, but not enough to keep any of them going’.* Another interviewee shared the worrying belief that while some lead providers worked in good faith, others almost seemed to design their supply chain to win a bid, but in expectation that some providers would fail and drop out of the contract, allowing the lead provider to take on a higher proportion of delivery—and therefore income.

‘With the best value model they're using now, you put in stretch targets against the money... So it's a gamble, if you don't meet targets, you lose income… and [there is a question] about where the risks lie. Lead partners in supply chains can probably afford the gamble as the risks lie with supply chain, so loss of income won't affect them as much as the organisations at the bottom of the chain. This threatens survival of those organisations.’

VCSE provider

These niche providers hold specialist expertise, community relationships, and frontline experience. If subcontracting relationships threaten their future sustainability, this would represent a loss for Kent’s communities and for commissioners who value their expertise. Responsibility for improving the current model is shared between KCC and lead providers. KCC should ensure incentives for lead providers are encouraging certain behaviours, for example through market positioning statements about the responsibility of lead contractors, or by stating a maximum proportion of the overall contract that can be delivered by the lead provider.

Improvements within the existing model

Below we outline barriers to FCR and recommendations for supporting VCSEs and other providers to engage in commissioning on a FCR basis. This section focuses on improvements within the current commissioning model. Some issues have been covered elsewhere in this report in more detail, and in these cases we share only the headline findings and recommendations.

Develop a common language and approach to FCR

Finding: There is a lack of common understanding and language around FCR. This leads to inconsistency of practice on both sides. It also makes it difficult to have useful discussions about how to improve the situation.

Recommendation: Use the information and scenarios in this report as a foundation for common understanding, and a more nuanced discussion about the challenges in specific contracts.

Several commissioners feel the VCSE has good understanding of FCR, referencing support around budgeting as VCSEs moved from grants to contracts. Nonetheless, KCC stakeholders are aware of the issues facing VCSEs with regards to FCR and are eager to increase clarity. There is a strong desire from VCSEs for the definition and application of FCR to be consistent across different directorates and between different commissioners. Both sides feel that an agreed definition of FCR is missing, and both would benefit from resolving this. This is not an issue specific to Kent—national interviewees feel that there has been relatively little guidance or discussion about FCR recently, especially guidance which recognises the constraints on commissioners.

Create a shared and consistent approach to overheads

Finding: although all parties acknowledge that overheads need to be factored into FCR, there is no consensus on what types of overheads should be included, or at what level.

Recommendations: Start a detailed and transparent conversation between the VCSE and KCC about the way to deal with overheads in contract budget templates. Move towards a consistent approach which allows VCSEs to present their overheads accurately.

Need for a consensus on types of overheads

There is an overall sense of lack of consensus on overheads. Both VCSE and KCC stakeholders referred to concepts like ‘a fair proportion’ of overheads, but neither had a clear definition of what a ‘fair’ proportion would be or how it should be calculated.

Some VCSEs feel KCC only recognises overheads associated with running a service, and not with running an organisation. Several referenced KCC’s stance that it was ‘funding services, not organisations’. This was not the message we received from commissioners, who recognise that overheads include a contribution to organisational overheads.

VCSEs stressed that many overheads are associated with quality assurance, including compliance with KCC reporting requirements; cyber security accreditation; and registration with regulators such as CQC. Interviewees also noted wider costs such as trainings and supervisions, to ensure there are high safeguarding standards when working with vulnerable groups. Some of these overheads might appear to be distinctive to VCSEs which routinely deliver contracts supporting vulnerable individuals, but in fact pertain to the nature of contract. Nonetheless, organisations may experience the burdens of these overheads differently due to their size or income profile.

We heard some consternation from KCC stakeholders about what overheads they felt it fair to cover; particularly overheads such as fundraising. Some KCC stakeholders are concerned that not all commissioners know what the ‘right’ overheads might be, and some expressed a desire for more guidance.

‘I would love there to be a document that sets out what would and would not be covered, but there is not, so then it becomes dependent on the expertise of the commissioner.’

KCC stakeholder

If there is an implicit expectation that certain costs will be funded elsewhere, this should be made explicit. Equally, providers should not try to ‘hide’ costs when bidding, and should reconsider actions that risk undercutting other VCSEs by exercising market stewardship.

The need for a consistent and widely understood approach to overheads

VCSEs feel that there is not an accepted ‘standard’ methodology applied to overheads—and by extension, FCR—in Kent. VCSEs expressed seeing huge variation in approach and culture between commissioning teams, policy makers and procurement managers. There is a perception that contracts given to different organisations cover different levels of overheads, without a clear rationale behind these decisions. The lack of clarity and consistency in this area is straining relationships between VCSEs and KCC, and there is confusion from both sides as to what costs should or should not be covered and how to determine this.

Some VCSEs argued in favour of KCC funding a *proportion* of overhead costs, rather than asking providers to provide a granular budget based on the *types* of overheads it is willing to fund—within reason. Responses from KCC and VCSEs suggested that a certain percentage of overheads is included in contracts as standard, although there was no agreement as to the exact percentage level of overheads to be included, with responses varying between 10% to 20%.

One peer authority had experienced success with this approach, and it had favour with some parts of the VCSE, although we did not test the idea systematically with all VCSEs. One VCSE indicated this practice would be standard in the private sector.

'I come from a private sector background so I will tend to include a flat-rate margin rather than working out my overhead costs per item.'

VCSE provider

The need for budget templates which align with VCSE budgets

Many VCSEs mentioned struggling to articulate their true costs within existing budget templates. Many noted that their definitions of what constitutes a direct or overhead cost clash with the way overheads are defined and permitted in budget templates. As a result, guidance on permitted types and levels of cost do not reflect the realities of VCSE budgeting.

VCSEs fit their figures into the permitted categories as best they can. This exacerbates the difficulty of submitting a FCR budget. It also means commissioners don't have the benefit of building experience over time by seeing how VCSEs build and allocate their budgets. This issue is made more difficult because the task of distinguishing between direct costs, service-related overheads and organisational overheads is not straightforward and different VCSEs categorise costs in slightly different ways (see Appendix B).

Since this specific issue is not about increasing the overall budget for overheads, but looking at how they are categorised in tender responses, adjusting these templates could be a relatively easy adjustment with benefits for all parties.

Ensure adequate publicity time for VCSEs to mobilise

Finding: Providers who are not regularly engaging in commissioning—including, but not limited, to VCSEs—need time to mobilise resources to submit a high-quality bid.

Recommendation: Ensure existing standards of good practice about tender submission timelines are consistently followed.

Several VCSEs mentioned challenges with the visibility and timeframes of commissioning opportunities. There was a feeling that KCC often gets this right, but not consistently.

Contracts are consistently advertised on portals, but VCSEs have inconsistent experience of KCC sharing information through networks about forthcoming contracts. This is valued where it happens, with VCSE leaders commenting that it isn't practical to speculatively check the portal on a weekly basis. We heard examples of tender processes being open for only a couple of weeks, or over a peak holiday season when staff are likely to be on leave. Working in a rushed way makes it more difficult to consider risks and compile a FCR budget. This challenge is exacerbated in collaborative or lead contractor models.

In addition, many VCSEs do not have permanent staff dedicated to bid writing and need to release time for the chief executive and senior staff to support this process—which cannot happen quickly. For small VCSEs, a relatively small finance team must also assess the risks and realities of budgeting and delivering work for different income streams. This is very different from an organisation working at scale on multiple contracts, with a finance team that deals with the challenges of FCR contracting repeatedly.

Build VCSE skills and knowledge

Finding: VCSEs and other small providers may not have the skills or experience to predict and avoid pitfalls.

Recommendation: Engage with VCSEs to understand their commissioning training and support needs, and provide that support. This might be provided through training programmes, but it may make most impact through developing supportive relationships between providers and commissioners.

VCSEs with limited experience of, and resource dedicated to, tendering processes can experience challenges. This is particularly seen in small VCSEs, where staff are likely to be low on capacity and time-poor, and there are not teams or individual staff dedicated to bid-writing and calculating costs. It is challenging for VCSEs of all sizes to anticipate all costs and potential future cost variations, as the costs of delivering a service depend on a host of variables, and so this challenge is magnified in small VCSEs.

'I would like VCSEs to have a greater business grip on what their model means when they are bidding for specific service. My overall feeling is that they don't understand the risk they are taking on and don't realise it until too late.'

KCC stakeholder

For those with less experience of working with contracts and bids, it can be particularly difficult to unpick the details of variations in payments; for example, where a proportion of places are directly funded by KCC, but others are funded indirectly through direct payments to individuals. Bidders might struggle with FCR in other ways, for example, in factoring in inflation or the time needed to report using certain systems. Where commissioners do not have the time, inclination, or resource to explore proposed budgets with potential providers in detail, discrepancies can easily emerge. Some stakeholders noted that bigger organisations are more likely to have been 'bitten' by similar difficulties in past contracts, and are therefore more able to anticipate and avoid these.

Some KCC commissioners spoke about proactive, detailed work to check the realism of budgets submitted by providers, through dialogue with the preferred provider and with the wider market—offering an opportunity to re-price based on these conversations. However, it's not clear whether this is a KCC-wide approach.

A mixed model of support may be most effective here. This could involve training from KCC; peer support from other VCSEs; and developing supportive, 'troubleshooting' relationships between providers and commissioners.

Build commissioner skills and knowledge

Finding: VCSE providers feel that commissioners lack practical knowledge of how their budgets and overheads work, which leads to avoidable barriers to their participation in commissioning on a FCR basis.

Recommendation: Build commissioner familiarity with VCSE budgets, including the overhead and support costs necessary to deliver a quality service. Ensure commissioners have support to achieve this, for example through training.

With a greater understanding of VCSE budgets and overheads, commissioners might notice commissioning structures which inadvertently and unnecessarily make it more difficult for VCSEs to access commissioning opportunities and deliver on a FCR basis.

There was a clear message from VCSEs that commissioners do not understand how VCSE budgets are put together, and therefore commissioners do not understand the rationale for including certain overheads in a FCR budget. Appendix B offers a starting point for commissioners seeking to understand the reality of VCSE budgets.

We also heard from some providers that over time, commissioning has become more ‘professionalised’, with fewer commissioners coming from a service delivery background. From the VCSE perspective, this means the commissioners are less likely to understand the nuances of the VCSEs’ work and the full range of costs involved:

‘Commissioners for social services used to come up through the ranks of social services, so [commissioning] was much more based on an understanding of what things were really happening on the ground, and what needs really were.’

VCSE provider

It is not clear that KCC has access to the information needed to assess whether providers can realistically deliver contracts in a FCR way. Elsewhere, we have discussed the opportunity to include greater VCSE insight into commissioner understanding of community needs, and an accurate assessment of the costs of delivering services at quality.

Responsibility for these knowledge gaps is shared. VCSEs acknowledged that they could be more direct in their relationships with commissioners, for example by feeding back on the feasibility of proposed contract pricing in the light of community needs, and requesting changes to budget templates rather than fitting their costs into unsuitable frameworks.

Improving trust and transparency

Finding: Improving transparency was an important theme that emerged in this research. This speaks to a wider issue of building trust based on clarity of approach, so that providers can use available information to make good decisions.

Recommendation: Ensure openness and transparency, particularly in market engagement. Strive towards open communication and consistency to help foster trust.

The theme of ‘transparency’ encompasses some specific issues discussed in more detail elsewhere in this report:

- The need to conduct market engagement in an open way and avoid the perception that a few favoured bidders form an ‘inner circle’.

- An interest from VCSEs to understand how KCC sets budgets and assesses levels of need.
- A responsibility from the VCSE sector to be transparent and let KCC know what it feels is feasible and fair—and not hide these challenges to achieve competitive advantage.
- The need for open dialogue to improve VCSE understanding of KCC's constraints, which may extend beyond budget to ways of working and statutory concerns.

The theme of 'transparency' also speaks to a wider issue beyond specific systems and processes. While many VCSEs spoke about positive individual relationships with commissioners, inconsistent practice contributes to tension and mistrust. Some VCSEs stated that the detail of KCC's approach is less import than knowing exactly *what* the approach is, and seeing it consistently applied. This would help VCSEs to feel more confident in decision-making and would support both parties to undertake commissioning in good faith. While this recommendation represents *'Improvements in the existing model'*, it is the foundation of *'Moving towards a new model of shared responsibility'.*

The role of data

Finding: KCC has limited data available to build understanding of FCR.

Recommendation: Consider how to develop existing data to improve understanding of the VCSE in commissioning, and questions relating to FCR.

NPC hoped to include a data-methodology in this research, by analysing the costs and outcomes of VCSE providers. This has not been possible for data access reasons, and we understand work is underway to improve the tagging of contract providers by sector. Data is always a challenge, and KCC is ahead of many authorities in the work it does to calculate its annual spend with the VCSE.

Without data on providers, however, it is not possible to assess how VCSE overheads compare with other providers. There is also no visibility of subsidy, and as a result KCC has no sight of where this presents a risk—an increasing challenge under inflationary pressures. Neither does KCC calculate the degree to which VCSEs offer 'added value' through bringing additional resources to contract delivery. We encourage KCC to think about the research questions it wants to answer in relation to FCR and the VCSE in commissioning. These questions might be answered using financial and outcomes data collected through contracts. With a data-driven approach, KCC could go further than identifying key issues to determine how common an issue is, or how severe.

Moving towards a new model of shared responsibility

Finding: Improving existing commissioning practices will reduce problematic non-FCR contracting. However, the underlying tension of how to achieve shared aims within constrained budgets remains.

We might have expected to discover FCR was a technical question about KCC processes and VCSE sector skills—and those issues are relevant. Improving existing processes and building skills will help to avoid situations where FCR cannot be achieved. It will also help all parties understand, acknowledge, and manage risks if contracts are intentionally entered on a non-FCR basis. However, the underlying issue is that budgets are stretched, and difficult decisions need to be taken about where to invest scarce resources. This issue will compound in the coming months as inflation rises and the cost of living crisis hits.

VCSEs can experience frustration that contract specifications don’t recognise and incentivise the achievement of long-term outcomes and long-term cost savings. KCC can likewise experience frustration that the VCSE doesn’t recognise its constraints and the difficult prioritisation decisions it needs to make.

If commissioning practices stay the same while budgets are reduced, two things can happen:

- **The quality of outcomes drops**, meaning people in Kent receive poorer services. This may lead to greater—and higher cost—needs in the medium-term.
- **The provider picks up the shortfall**. This may initially seem beneficial to KCC, but it creates a risk to organisational sustainability and service continuity. Over time, it also disguises the true costs of achieving long-term change, meaning KCC lacks insight which is essential to good budgeting decisions.

What could a new model of shared responsibility look like?

Finding: KCC and VCSEs need to be transparent about their difficult choices in order to acknowledge the risks and rewards of different contracting decisions.

Several recommendations relating to this finding are covered in detail elsewhere in this report:

- **Engage VCSEs in the design and price of contracts** to ensure they are based on the best insight about the nature and scale of needs and the cost of delivering a quality service.
- **Reframe the role of the commissioner** to one based on partnership, with recognition that mutual understanding will lead to fewer unintended consequences.
- **Develop scoring criteria to reflect the value of achieving long-term outcomes.**

In addition, the VCSE and KCC need to be transparent about their own difficult choices. For KCC, this might include sharing more information about how budgets are set, and the way decisions are made within constraints. For VCSEs, this might include explaining the costs of achieving quality, and not hiding costs to gain competitive advantage. Both parties need to acknowledge the risks and rewards of different contracting structures and specifications to enable joint problem-solving. This can only happen by building trust, so that there is no pressure to hide points of difficulty.

Embracing co-production

Finding: Thinking differently about commissioning, and moving towards a co-produced approach, requires time and resource. This requires strategic buy-in from across KCC.[6]

The reality of stretched budgets, increasing demand, and economic pressure brings an imperative to think differently about achieving outcomes. Greater VCSE involvement in service and contract design could help develop innovative approaches, and manage the risk that budget cuts will lead to poorer outcomes for people in Kent. This would require a fundamental shift in relationships between commissioners and delivery organisations, and so requires a consensus and shared strategic decision between commissioners, elected members, and policy experts.

This shift from commissioner-provider power dynamic to a partnership could create space to design solutions based on a shared understanding of the cost required to deliver at quality, and to draw the maximum benefit from the expertise and strengths of different organisations. It would mark a further step in the evolution from grants, to commissioning contracts, to co-production.[7] While co-production can be time- and resource-intensive, we heard from peer authorities and national experts that it is essential to achieve the ambition of ‘doing things differently’.

[6] This research was not designed as a wholesale review of KCC’s commissioning model and alternative approaches. We have endeavoured to articulate this alternative approach, but this has not been researched systematically.

[7] Co-production here refers to the partnership of KCC and VCSEs. True co-production would involve communities. While VCSEs can be a valuable conduit to communities, this is not the same as hearing the voice of communities directly.

Conclusion

Responsibility for FCR does not lie solely with the commissioner, nor solely with the provider. In addition to the overall budget available, it rests on the skills of the provider organisation; the knowledge and flexibility of the commissioner; the structures of commissioning which incentivise positive provider behaviour; and relationships based on transparency and openness. Relationships need to be fostered by fair, consistent commissioning structures which build on the expertise of the VCSE, enable them to make good decisions based on predictable practices, and support fair access of small providers to the marketplace.

This report shares recommendations for both KCC and its VCSE partners for making improvements within the existing commissioning model. These recommendations would hugely support the VCSE in achieving FCR in contracts and thereby support KCC to manage risks and achieve outcomes for Kent residents. However, the tension remains between KCC's budgetary pressures and the VCSE's drive for achieving long-term outcomes. Tackling this tension requires a more fundamental rethink of the commissioning model, towards equal partnership through co-production.

The motivation of this research is not to protect the VCSE. The aim is to ensure that people in Kent receive the highest quality of service, recognising that the VCSE is an important and sometimes uniquely placed partner in the delivery of those services. In fact, it is this shared goal of delivering positive outcomes for people in Kent which is distinctive to VCSEs. The FCR conversation therefore is about managing a shared risk effectively—the risk of service discontinuity through non-FCR contracts undermining providers' sustainability.

There are important reflections for VCSEs here, and especially for lead contractors. VCSE practices of subsidising services to gain competitive advantage can undercut peers and make it more difficult to make a collective argument about the true costs of delivering a high-quality service. There is a need for frankness from the VCSE in influencing commissioning practices, as well as a need to balance the competitive dynamics of commissioning with collective approaches. If KCC takes the brave decision to explore new models of commissioning, it will need VCSE partners ready to adapt and change, keeping the people of Kent, rather than their individual organisations, at the centre.

Appendix A: Context and definitions

What are commissioning and procurement?

Procurement is a process through which an organisation buys goods or services from an external partner. Public bodies use procurement to secure a wide array of services, from road maintenance to support for people with complex needs. Procurement exercises are often competitive processes open to prospective providers from different sectors, although other tools are available.

Commissioning refers to a wider process through which services—especially complex ones—are scoped and designed in response to a thorough understanding of needs, before being purchased—with the term 'procurement' referring specifically to the buying stage. This process is outlined in the commissioning cycle (Figure 1), which lays out five stages through which a service is designed, the market is developed, and the service is purchased and delivered before being reviewed to learn for the future.

Figure 1: The commissioning cycle[8]

In local authorities, commissioner roles are distinct from procurement roles, and both teams have a role in the way the process is designed, conducted, and experienced by potential delivery partners.

Charities are most often involved in delivering services to support individuals, communities, or places. In some cases, these are statutory responsibilities of a local authority, for example support for

[8] Image: NCVO / Knowhow nonprofit

people qualifying for social care; on some occasions these are services previously delivered in-house by the authority. In other cases, non-statutory services have previously been funded through grants to VCSEs, and these relationships are moved onto a contract footing. As NPC has explained in a previous report:

'When public funders move from grants to a contract model, the formal, legal relationship changes. Under a grant, organisations propose a way to meet the funder's objectives and funders choose whether to support them. Under a contract, an organisation is legally obliged to deliver a service according to a specification.'[9]

What is the law governing commissioning and procurement?

The Social Value Act of 2013 gives a legal basis to consider non-financial factors in bid scoring and contract awards. The act has been criticised as a 'tick box' exercise. It is often used to recognise value-add benefits such as sustainable environmental practices or local employment benefits, rather than to recognise the achievement of long-term outcomes through the core contract specification. Many VCSEs feel the Social Value Act has had little impact in changing the way contracts are awarded.[10]

Public Contract Regulations of 2015 is the translation of EU law into UK law. It states that procurement must abide by the principles of equal treatment; non-discrimination; transparency; and proportionality. This legislation underlined the move from awarding contracts based on lowest cost to awards based on *'Most Economically Advantageous Tender'* or MEAT—a balance of cost and quality.

The current Green Paper, **'Transforming Public Procurement'**, signals the intent of Government to continue in this direction of recognising the balance of social outcomes and economic value. The stated intention is:

'To simplify procurement processes and legislation, embed social value in procurement decisions and provide opportunities for small businesses, charities and social enterprises to innovate in public service delivery.'[11]

[9] *NPC, Times of change: What grant-makers and philanthropists need to know about public sector commissioning*, 2015.

[10] NPC, *State of the sector*, 2020.

[11] CIPFA, *Unlocking Potential, Realising the role of local charities in public service delivery*, 2022.

What is full cost recovery (FCR)?

The National Audit Office Successful Commissioning Toolkit states that:

'The government and the Compact recognises that:

- *No activity can be undertaken without its provider incurring central administrative costs;*
- *Funders and commissioners have an interest in meeting their fair share of a provider's central administrative costs because that will help to ensure that the provider can manage its activities and finances properly, and will contribute to the organisation's sustainability.*

This means that your programme must finance its 'fair share' of all providers' administrative costs… If the provider is a charity, you must not expect it to subsidise the cost of your programme from donations that it receives.

Under procurement, it is up to:

- *The potential **provider** to bid at a **price** that it considers appropriate, taking account of all its costs*
- ***Yo**u [the commissioning authority] to accept (or not) that bid. In deciding this, you must consider whether the potential provider's proposed price is sustainable. You cannot give preferential treatment to third sector organisations (TSOs). However, as part of good risk management, you must check that any award will provide the degree of continuity of service required by the objectives of the programme.'*[12]

Guidance from the Charity Commission indicates that for statutory services—where a government authority is legally required to provide a service with no discretion over the level of provision—a charity provider should expect the governmental authority to meet the full cost. It acknowledges that a charity may choose to subsidise to enhance the level service above that required by law and by the contract specification, if its trustees decide this is a good use of funds.[13] Generally, funders and commissioners have an interest in meeting their fair share of a provider's central administrative costs, because this helps ensure that providers can manage their activities and finances effectively and will contribute to the organisation's overall sustainability.

[12] The National Audit Office Successful Commissioning Toolkit, *Full Cost Recovery,* 2011.

[13] The National Audit Office Successful Commissioning Toolkit, *Full Cost Recovery,* 2011.

Appendix B: Financial case studies of VCSEs

How do VCSEs classify 'direct' and 'support' costs?

The Charity Commission defines 'direct' costs as those *'which result directly from undertaking the activity'*, while 'support' costs *'are costs incurred to facilitate an activity'.*[14] Support costs tend to be incurred across multiple activities, while direct costs are incurred from a specific activity. Support costs include 'back office' or infrastructure functions that are essential for allowing frontline delivery to operate effectively and at a high standard.

Different VCSEs will have different ways of categorising direct and support costs. This section compares Organisations A, B and C to explore how they categorise these different costs. All figures in this analysis have been rounded to protect anonymity.

Some of the common VCSE costs outlined in this section include:

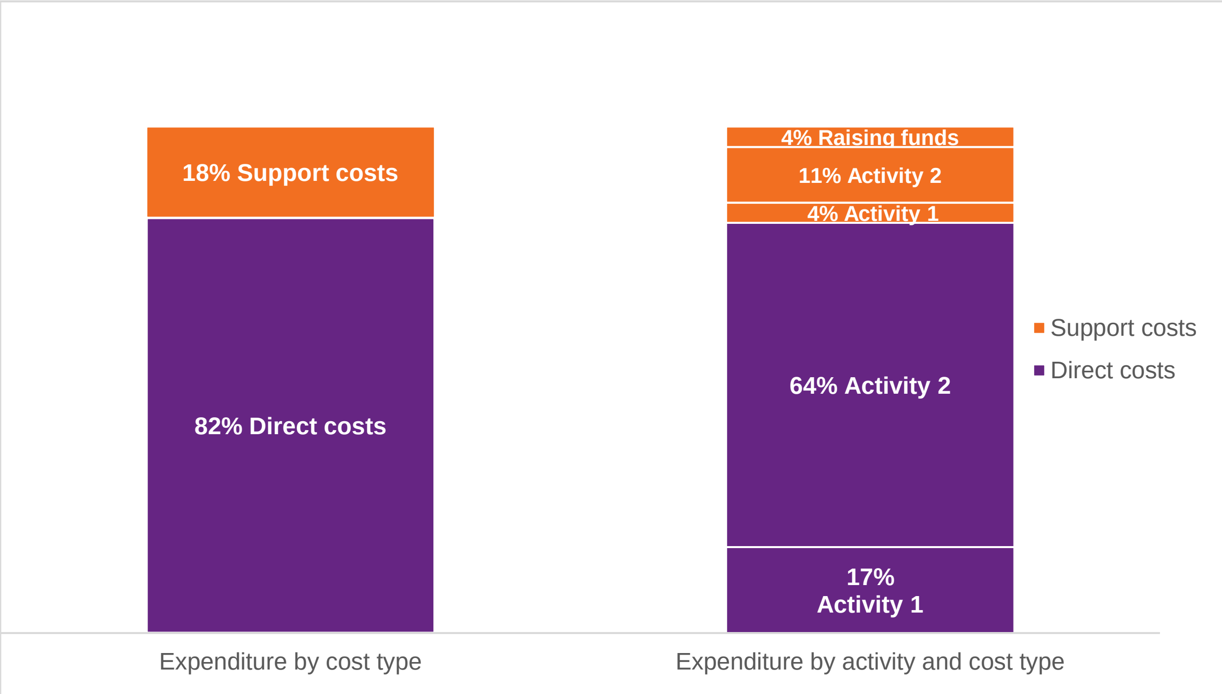
- **Staff costs**, which typically represent the wages and salaries, social security costs, and pension costs of all employees. Other staff-related costs, such as travel, training, and clinical supervision, are typically accounted for separately.
- **Governance costs**, which might include auditing fees, or one-off governance costs for example if an organisation is going through a merger process.
- **Premises costs,** for example room hire or rent needed for service delivery.
- **Office costs,** for example costs for using phones, IT and database systems, and other office equipment.
- **Volunteer costs,** for example volunteer supervision, training, and expenses.

In this section, we have used **purple** to represent direct costs, **orange** to represent support costs, and **pink** to represent combined direct/support costs.

[14] Charities sorp, *Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland*, 2019.

Organisation A

Figure 2: Organisation A's expenditure by activity and cost type.

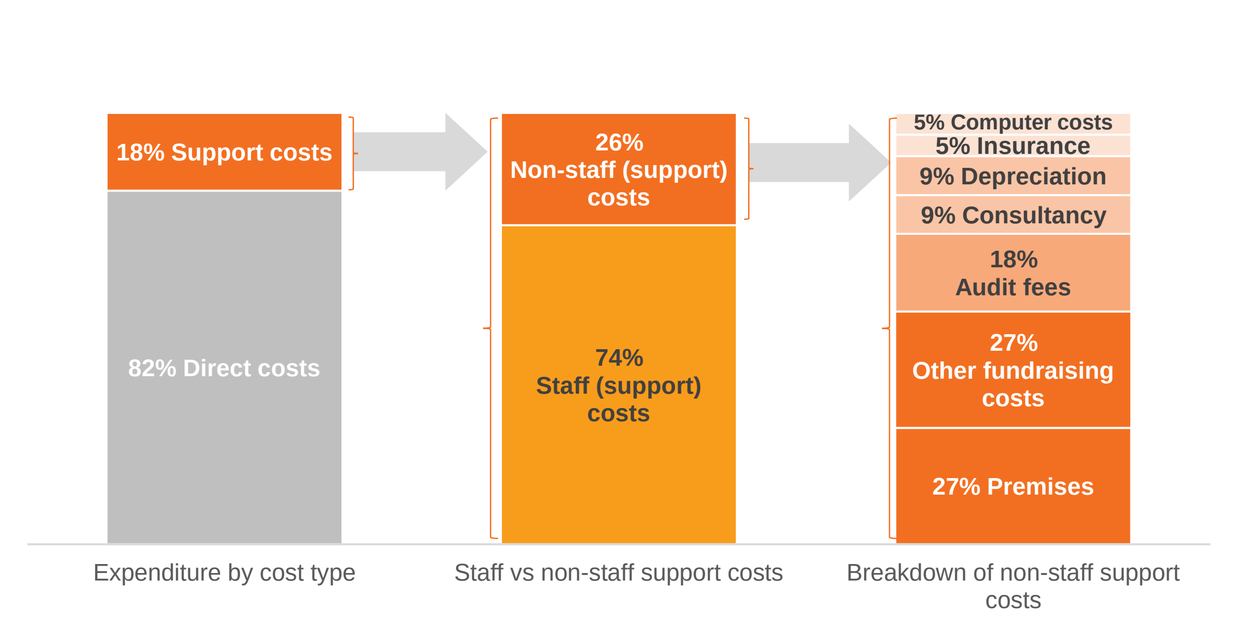


Organisation A's total expenditure for 2020-2021 comprises £1,100,000, of which 82% is direct costs and 18% is support costs. Its direct costs comprise mainly of staff costs (76% of all direct costs), which reflects all staff costs involved in directly delivering its activity programmes. Its direct costs also include:

- Transport expenses (9% of direct costs).
- Premises costs (5%).
- Depreciation (4%).
- Office costs (3%).
- Staff recruitment, travel and training; computer costs; and consultancy fees (total 2%).

Its support costs are again mainly comprised of staff costs (74%), which reflects wider staff costs needed to run the organisation and support delivery. Other support costs for Organisation A are broken down in Figure 3 (excluding <1% comprised of other office costs and other direct costs).

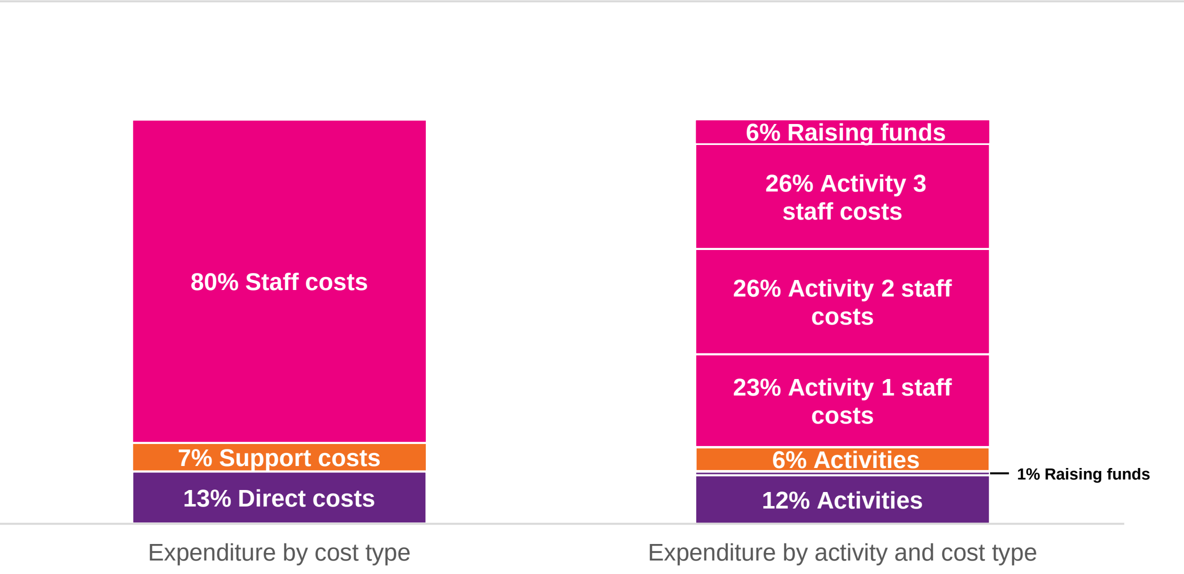
Figure 3: Organisation A's support costs by activity.



Organisation B

Unlike Organisation A, Organisation B has chosen to decouple its staff costs from direct or support costs, and reports on these separately. Overall, Organisation B's total expenditure for 2020-2021 comprises £1,250,000, of which 80% is staff costs, 13% is direct costs and 7% is support costs.

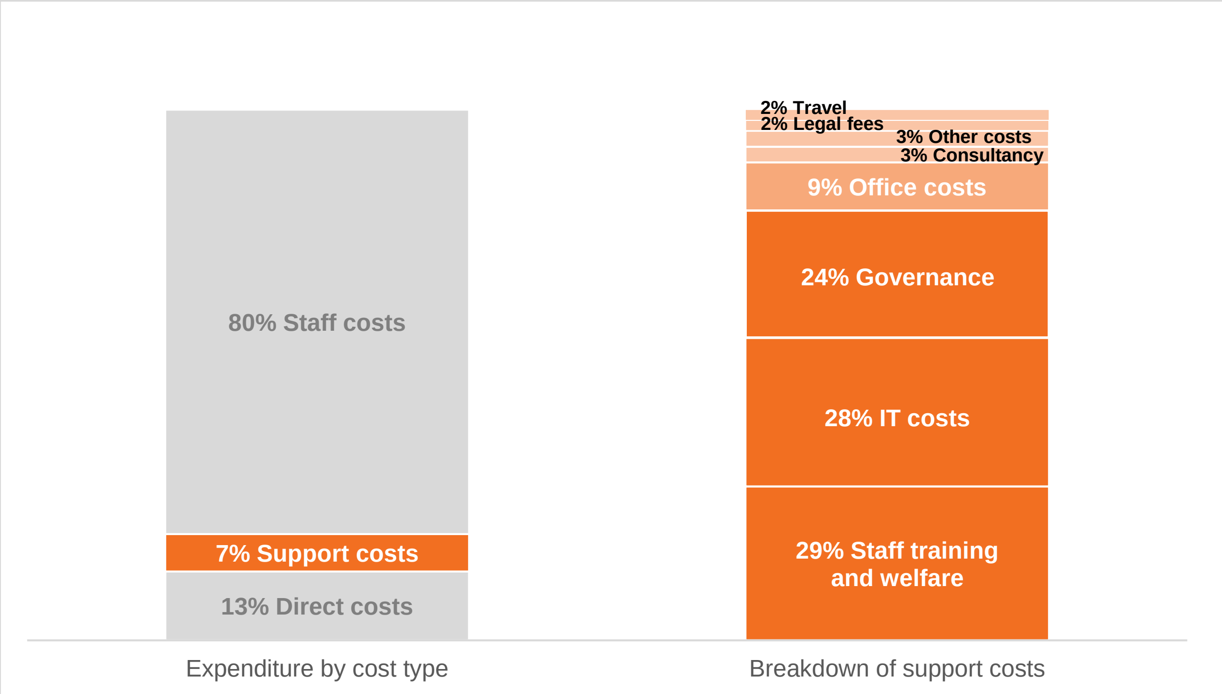
Figure 4: Organisation B's expenditure by activity and cost type.[15]



[15] Support costs for raising funds represent <1% of total expenditure and are not represented here.

Organisation B's direct costs include staff travel, training and supervision; volunteer costs; office costs; and premises costs. These costs are similar to those presented by Organisation A. Similarly to Organisation A, Organisation B's main support costs are related to staff (Figure 5).

Figure 5: Organisation B's support costs by activity.



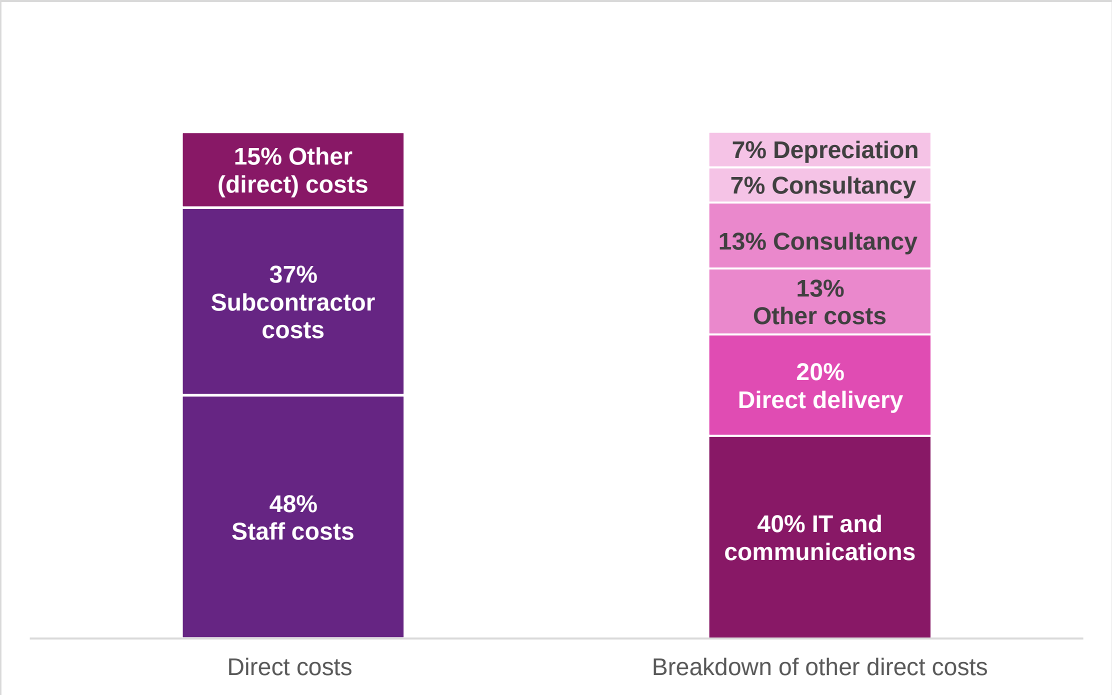
Organisation C

Organisation C's total expenditure for 2020-2021 comprises £7,000,000, of which >99% is direct costs and <1% is support costs. Unlike Organisations A and B, Organisation C's support costs includes only governance costs, of which 76% comprises auditing fees.

As with Organisation A, Organisation C's direct costs mainly comprise of staff costs (48%). As Organisation C holds a lead provider position within certain contracts, its subcontractor costs comprise another 37% of its direct costs.

The remaining 15% of its direct costs are broken down in Figure 6. (This excludes travel costs; printing, postage and stationery; training costs; marketing and development; and other staff costs, which in total combine to 1% of all direct costs). These costs are similar to those presented by Organisations A and B.

Figure 6: Organisation C's direct costs by activity.



Implications

As we can see from analysing these three organisations, there are some common VCSE support costs, such as staff costs, premises costs, and IT costs. Overall, there are a variety of different support costs contributing to quality service delivery, and these can't be easily disentangled; all are equally important. While it can therefore be difficult and counterproductive for commissioners to 'pick and choose' different support costs to fund, it is important to evaluate whether support costs seem proportionate to the size of the VCSE and to its comparative delivery costs. VCSEs also need to make it clear what they categorise as support costs versus direct costs.

What do VCSE income streams look like?

VCSEs finance their charitable activities through a range of different income streams. According to NCVO's Almanac for 2021, the two biggest sources of VCSE income are earned income (47%, e.g. generated through contracts, membership fees, trading, events), and 44% is voluntary (e.g. donations, grants or sponsorship).[16] The largest source of this income is the public (48%), followed by government (28%, including grants and contracts).

[16] UK Civil Society ALMANAC, *Where do voluntary organisations get their money from?* 2021.

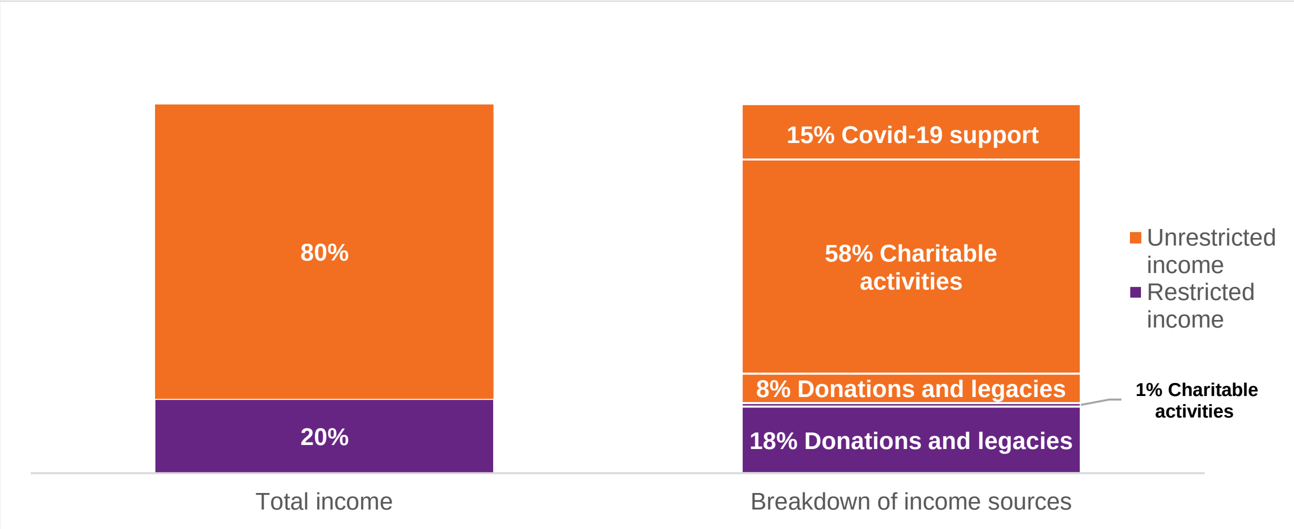
VCSEs receive both restricted and unrestricted income. Restricted income can only be used to finance specified activities, while unrestricted income is more flexible and VCSEs often rely on this to finance the majority of core costs.

This section compares Organisations A, B and C to explore how they are funded.

Organisation A

Organisation A's total income for 2020-2021 comprises 26% in donations and legacies, 59% from charitable activities (i.e. earned income), and a further 15% in Covid-19 specific support. Figure 7 shows the breakdown between these sources in terms of restricted and unrestricted income.

Figure 7: Organisation A's income sources.



Overall, Organisation A's income is comprised of 20% restricted income and 80% unrestricted income. Its biggest source of restricted income was from donations and legacies, which comprised donations from Trusts and Foundations, companies, and some other sources. Around 15% of this money was able to be spent on previously outlined support costs, with 66% spent on previously outlined delivery costs, and the remainder spent on specific equipment.

Organisation B

Organisation B's total income for 2020-2021 (£1,400,000) comprises:

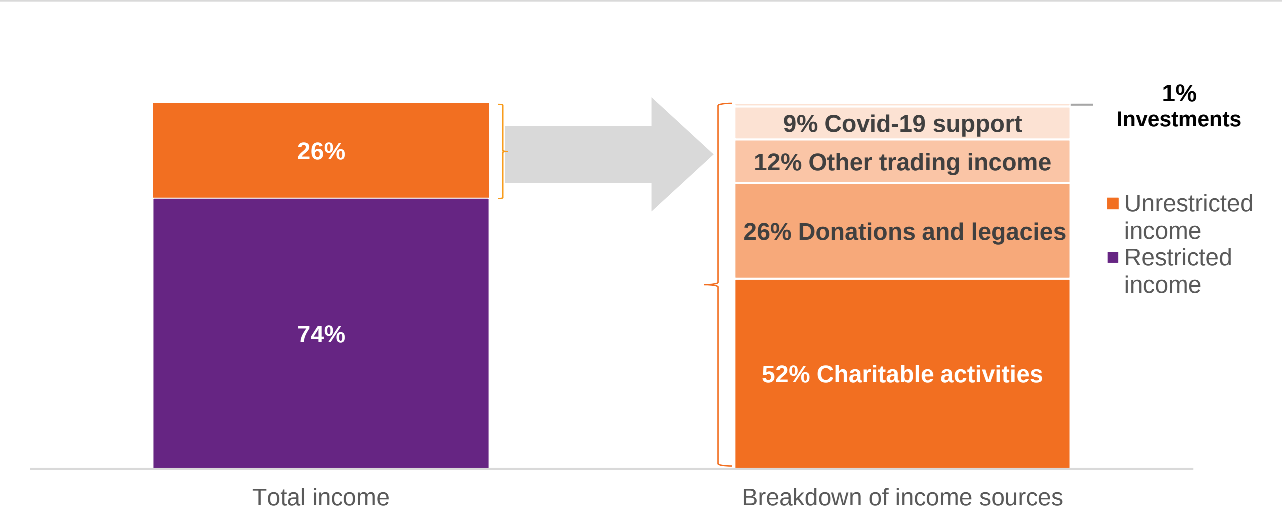
- 8% in donations and legacies.
- 89% from charitable activities.
- 3% in other trading activities, including consultancy work.

- 3% in Covid-19 specific support.
- <1% in investments.

Unlike Organisation A, Organisation B's main source of income is charitable activities, which mainly comprises money from various Trusts and Foundations as well as commissioned services.

Overall, Organisation B's income is comprised of 74% restricted income and 26% unrestricted income. Again, this is different to Organisation A, where most funding was unrestricted. This may be because Organisation B's main source of funding—grants and contracts—is more likely to be restricted than money from donations. Figure 8 shows that Organisation B's biggest source of unrestricted income was still charitable activities, but this only represents 17% of all charitable activity income.

Figure 8: Organisation B's income sources.



Organisation C

Organisation C's total income for 2020-2021 (£7,600,000) comprises:

- 4% in donations and legacies.
- 93% from charitable activities.
- 3% in Covid-19 specific support.
- <1% in investments.

Overall, Organisation C's income is comprised of 8% restricted income and 92% unrestricted income. 46% of restricted income is from donations and legacies (mainly in the form of fixed assets, e.g. property), and 54% is from charitable activities income. Organisation C has the highest proportion of unrestricted to restricted income out of the three organisations.

Implications

Ideally, VCSEs want to bring in as much unrestricted income as possible, as this helps to cover core costs and can be used flexibly as circumstances shift. However, this is not often a reality, particularly for VCSEs like Organisation B that have delivery models reliant on grants and contracts. It may also be easier for lead organisations in supply chains, or bigger national organisations, to secure this unrestricted income; they are further removed from frontline delivery and are more likely to have the skills and capacity to secure unrestricted income.

Commissioners should bear in mind that a flexible approach on how money is spent, as well as a flexible approach to reporting requirements, could build capacity in these organisations and ultimately deliver better long-term outcomes.

Does VCSE income cover support costs?

Unrestricted funding is referred to as 'gold dust' in the VCSE sector; for many VCSEs, it can be a challenge to secure the desired level of unrestricted funding to cover support costs. This can lead to VCSEs subsidising activities using several income sources, and in some cases using reserves.

The Charity Commission advises charities to retain a level of unrestricted income as reserves, which the organisation can then use freely to protect itself against any sudden drop in income or to pursue new activities.[17] Charities must have a clear reserves policy, and generally three to six months' reserves is considered a healthy level, though there are reasons an organisation may wish to hold more than this, e.g. in periods of low growth.[18]

This section compares how income maps onto expenditure across organisations A, B and C.

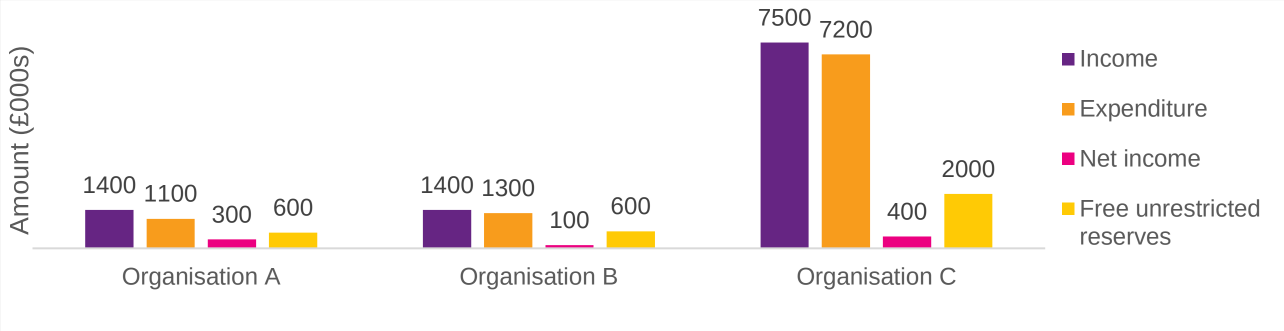
Does income cover expenditure?

For all three organisations, income covers expenditure, leaving a small amount of net income which can be carried forward as reserves (Figure 9). Organisations A and B ended the year with ~six months of free unrestricted reserves, and Organisation C with ~three months' worth.

[17] Charity commission, *Charity reserves: building resilience*, 2016

[18] NPC, *Keeping account: A guide to charity financial analysis*, 2013.

Figure 9: Organisation A, B and C's income, expenditure and net income (£000s).[19]



Overall, all three organisations were able to cover their total expenditure. However, for organisations like Organisation A, which had ~£200,000 in support costs, this was sufficiently covered by its unrestricted income. For an organisation like Organisation B, where a higher proportion of its income is comprised of restricted money from grants and contracts, this is more likely to mean the organisation needs to supplement activity support costs with money from fundraising or reserves. While Organisation B only had ~£90,000 of support costs, it also had ~£1,000,000 in staff costs and only ~£400,000 total in unrestricted income. Some staff costs were likely covered by restricted income from grants and contracts, but only where explicitly agreed. For organisations A and B in particular, which did not generate such a high proportion of unrestricted income, the money needed to cover core costs is likely to be spread across several sources of income.

Implications

A single grant or contract may not cover all the costs for a particular activity or service. Likewise, although an organisation may have enough total income to cover its expenditure, this doesn't mean it can easily cover all costs, as this depends on the stipulations about restricted use.

Many organisations, particularly smaller and delivery-focused organisations, need to spread core costs across several sources of income. This can be tricky to manage, as organisations don't know how many successful bids they will submit. These organisations might ask funders or commissioners for more core costs than they 'need' for that particular service, as funding becomes a gamble; if other bids fail, this threatens their ability to deliver, and would require diverting more time and resource from delivery to fundraising in order to supplement income.

[19] Amounts rounded to the nearest £100,000 or £10,000 to protect anonymity.

Appendix C: Case studies of peer authorities

Surrey County Council

Perspective of case study: Strategic lead for Partnerships, Policy and Commissioning; commissioning lead for some VCSE-delivered services, including infrastructure.

What conversations is the authority having with the VCSE about costs in commissioning, especially regarding FCR?

Surrey County Council works hard to ensure value for money, and to ensure that services are commissioned based on need. FCR is not explicitly factored into their current processes, although when talking to and supporting the VCSE, potential bidders are advised to be aware of FCR in putting together their budgets, and to be mindful of their ongoing sustainability. However, one determining factor for choosing to work with the VCSE is because of the added value the sector brings.

Key issues or challenges the authority is trying to address

Surrey County Council is actively thinking about its relationships with and ways of working with the VCSE. It is about to embark on a strategic review of its relationship with the sector to ensure they are being the best partners they can be, and to ensure that the ‘right’ things are being commissioned in terms of infrastructure that aligns with priorities for the county.

Experiences of the VCSE during Covid-19

Demand on the VCSE significantly increased during Covid-19, and in parallel income revenues were severely disrupted, with challenges around continuing to operate through new means.

The Council’s response in supporting the VCSE during this time was robust and thorough. Partly using funding from Central Government and partly ensuring flexibilities to their own procedures, the Council helped to mitigate the impact of Covid-19 on the sector. It was able to provide extra support to the VCSE, for example through small grants to buy equipment, investing in new services such as a bereavement counselling service, and ensuring rental holidays for any organisation housed in Surrey buildings, alongside flexibilities to contractual obligations. This meant that most VCSE organisations were able to weather the storm during the pandemic.

Looking ahead, there is a challenge as Covid-19 funding comes to an end:

‘We will not have that same level of funding to continue in the same way. These services are likely to still be in high demand, but we won’t be able to fund them anymore... We took action as a result of the pandemic, which has created a different expectation and a potential challenge for some parts of the sector.’

‘The point that we are at now will be telling as some of the Government-led interventions are coming to an end or have already ended. Moving into a recovery and reset period, with additional challenges as people start to feel pinch of impacts of Brexit, Covid-19, inflation and so on, it may have serious impact on the fundraising capability of sector. It could cause some real issues going forward.’

Council practices which support the VCSE in commissioning

- Co-designing and working in collaboration with the sector to shape things and seeing what can be done differently.
- Developing place-based commissioning with residents at the heart of this, in line with the Council’s key priority of *‘empowered and thriving communities’.*
- Adopting a Community Network Approach, encouraging open lines of communication between the Council, partners and communities, and bringing together a range of skills and talents.
- Understanding the assets and strengths of communities and investing in discovering and responding to ‘need’ in creative ways.
- Ongoing use of the Surrey Compact which outlines six codes of practice around funding, procurement, engagement, equality and diversity, and working with communities.
- Incentivising and fostering partnerships and collaborations. For example, working with private sector suppliers looking at Corporate Social Responsibility and asking what they can do to provide social value. Surrey County Council also has a social value marketplace which aims to foster relationships between the public and private sector and the VCSE and promote Social Value opportunities based on needs which will most benefit communities.

Essex County Council

Perspective of case study: Head of Strengthening Communities (Public Health Team), but working across teams on voluntary sector commissioning and looking after infrastructure organisations (e.g. community council, parish councils).

What conversations is the authority having with the VCSE about costs in commissioning, especially regarding FCR?

The Strengthening Communities team tries to have open conversations with the VCSE sector about FCR and its model is built on the idea of covering a *'fair and equitable'* proportion of costs to ensure FCR for providers, who are also expected to submit *'reasonable'* costings in bids. Commissioning within Essex uses a guideline 12.5% figure for reasonable overheads within VCSE sector contracts, which is communicated with the VCSE sector. Essex expects this to include a proportionate allocation of costs covering admin, insurance, training, HR, relevant management costs, and so on. Essex expects a granular, transparent breakdown of VCSE budgets when looking at costs, including a full breakdown of management costs involved in running a particular service.

Key issues or challenges the authority is trying to address

The VCSE sector plays a valuable role in shaping the market for commissioning in Essex:

'They're an absolutely integral part of what we do, and a way to do things differently and in some instances more effectively.'

However, the team faces some challenges with consistency from the VCSE sector, where some organisations submit FCR bids and others don't necessarily have the skills to calculate this. To help create a more level playing field, the team takes a proportionate approach, for example by providing smaller VCSEs with microgrants (as opposed to contracts) to support them to develop their infrastructure. On the other hand, larger VCSEs *'that essentially function the same as a businesses'* are held accountable for covering full costs in contract delivery in the same way as private providers. It can be tricky to balance the roles of being supportive and holding VCSEs accountable:

'We're all about being developmental and giving away power and working together. But ultimately I'm also the person that has to hold [organisations] to account when things don't work.'

Essex pushes back on bids that seem to be priced either too low or too high, and works with VCSE providers to give reassurance and feedback during the development process. They also avoid awarding ‘loss leader’ contracts, as this *‘creates instability in the marketplace’.*

Experiences of the VCSE during Covid-19

Essex took a pragmatic approach during Covid-19, recognising that some contracted activities would become undeliverable and others would need to transition to new forms of delivery, such as online delivery. The sector therefore remained well-funded and there were no general issues with inability to deliver against contracts, due to this adaptive approach.

Practices which support the VCSE in commissioning

- **Providing lighter touch microgrants for very small VCSEs**, who cannot compete with larger VCSEs for contracts. This helps smaller VCSEs to grow and become more sustainable, with further support from the local CVS.
- **Offering procurement training** which may be particularly helpful for smaller VCSEs, covering topics such as legal advice, processes and partnerships, and intellectual property.
- **Using a codesign approach and encouraging collaboration between VCSEs.** This includes bringing together VCSEs to identify community needs; identifying relevant partners and getting them together to shape services and identify the best methods for reaching communities; and building relationships and encouraging VCSEs to submit joint bids.
- **Thinking about building long-term social movements, rather than short-term services.** The team recognises that it is not possible to *‘service our way out of’* different community needs, and that to achieve longer-term sustainability and outcomes for communities they need to think about building social movements within communities rather than just procuring services.

Cornwall County Council

Perspective of case study: Commissioning officer at Cornwall Council, working within wellbeing services.

What conversations is the authority having with the VCSE about costs in commissioning, especially regarding FCR?

Due to current budget pressures within Cornwall, Council commissioners have not engaged in conversations with VCSE about FCR. Rather, their focus is on partnership work to further support and develop the VCSE, and value for money with regards to the sector; in particular, methods to discover whether they are achieving value for money for specific projects. Cornwall commissioners see overhead costs as the responsibility of the provider to cover, as included in the funding. Cornwall considers the ability for the VCSE to leverage additional funds in contracts when making contract award decisions: it is a requirement for providers to submit information about the 'added value' they can bring, which includes both social value and financial value in terms of other grants.

Key issues or challenges the authority is trying to address

One challenge for the VCSE in Cornwall is that some of the organisations are too small or simply not in the position to deliver the entirety of a service. Therefore, Cornwall Council is actively encouraging partnership bids from smaller VCSE organisations, and the Council is keen for there to be a collaborative approach within the VCSE in Cornwall rather than a competitive approach. The Council's intention is to have fewer contracts overall going forwards, and instead have bigger contracts which cover a wide range of services.

The commissioners are also aware about the funding challenges within the sector and increased demand for support as a result of the further budget reductions and the pandemic.

Experiences of the VCSE during Covid-19

Early in the pandemic, the VCSE experienced challenges in terms of the financial burden of acquiring PPE and reduced fundraising opportunities. However, as services switched to remote ways of working there were positive impacts of increased access and attendance from beneficiaries at services which switched online. It's possible that a decreased need for office space will also prove to be of benefit to the sector. Overall, the pandemic did not significantly affect VCSE contracts in Cornwall: the local authority worked flexibly to vary contractual arrangements where needed, and services continued to be delivered, albeit in a slightly different way.

Practices which support the VCSE in commissioning

Cornwall Council is in the early stages of launching a commissioning program called **'Provider Collaborative'** which seeks to reduce competition among providers and promote collaboration across the sector, so that more organisations are working together to deliver services in cooperation. This has developed from the positive impacts achieved from a partnership contract the Council holds for a carer service, with the lead provider model working very well.

Leicestershire County Council

Perspective of case study: Funding Manager, managing a programme of small grants to VCSE organisations.

What conversations is the authority having with the VCSE about costs in commissioning, especially regarding FCR?

As budgets have been squeezed, Leicestershire County Council has found it more difficult to talk about FCR. The Council's expectation is that the provider budgets appropriately to deliver what they can within money available: the responsibility lies with the provider to include what they can within that budget in terms of FCR.

Key issues or challenges the authority is trying to address

In addition to its commissioned services, Leicestershire County Council has, for ten years, maintained a programme of SHIRE Community grants of up to £10,000 which are focused on preventative, community-based interventions, delivered by the VCSE sector.

In terms of commissioned services, the VCSE sector is recognised as a valuable supplier and best placed to bid for certain types of services/contracts. The County Council feels it has a strong VCSE sector and a constructive, positive approach to working with them.

Experiences of the VCSE during Covid-19

Some organisations took a hit to income; especially those who previously generated income through renting rooms, shops, or community cafes. A lot of emergency funding was made available to the VCSE sector via a range of nationally and locally available grants. Leicestershire County Council itself established an emergency funding package for VCSE sector organisations, which awarded 379 grants in 2020-21, totalling £2.6m. The Council felt the sector did well to adapt their service delivery and also benefitted from the emergency funding available.

Corporate commissioning went through each contract to understand the impact of the pandemic on service delivery. There was an understanding that services would not be delivered as initially intended, and there was lots of support and flexibility for organisations to use the money from grants and contracts as they saw fit.

The Council now faces questions about what happens next as demand for the SHIRE Grants programme will be in excess of the available funding and some organisations may be experiencing higher levels of need/demand for their services, as a result of the pandemic. The Council expects to be looking again at how circumstances have changed and what recommissioning looks like as contracts come up for renewal.

Practices which support the VCSE in commissioning

- The focus of the SHIRE grants programme is early intervention and prevention: promoting wellbeing and enabling people to remain independent, with a positive quality of life, within their own homes and communities, thus reducing the need for high-cost public services. Leicestershire is investing in community based non-clinical solutions such as mental health drop ins; counselling/therapeutic support; wellbeing in nature; arts and crafts, gardening; all of which are examples of social prescribing solutions which help to reduce, avoid, delay and prevent the need for more costly solutions. The grants go some way to covering what can't be afforded by commissioners.
- In the interests of promoting more collaborative approaches, the grants team made available grants of up to £25k for partnership projects, but received very few applications.

Appendix D: Methodology

This report was initially commissioned by KCC as an internal report, sharing high-level messages to the VCSE Partnership Board and VCSE Steering Group. The report was shared directly with the Cabinet Member, Leader, Policy Lead, and Head of Commissioning within KCC. It was then decided that the full report should be made publicly available to convey the nuance of the findings.

The primary methodology was structured interviews, using a standard guide based on research questions indicated in the original specification, and developed through consultation with KCC stakeholders and the VCSE Steering Group. Interviewees were identified jointly based on early conversations with KCC, the VCSE Steering Group, and NPC sector knowledge. We selected stakeholders to cover a range of perspectives and experiences. We conducted 41 interviews, including ten KCC stakeholders (including staff and elected members); 21 VCSEs (including lead providers and subcontracted organisations); four peer authorities; five national experts (including infrastructure organisations); and one private sector representative. In addition, we reviewed over 20 key documents—including documents specific to the Kent context, and wider discussions about the voluntary sector in commissioning—using the same research question framework.

Financial case studies (Appendix B) were developed using publicly available financial information and management accounting information shared by three Kent VCSEs. These have been anonymised and financial figures rounded, although proportions of cost are accurate.

This process covered a range of research questions but is far from comprehensive. There are areas where we have uncovered interesting themes and not had an opportunity to unpick these in detail or verify interviewees' interpretations. We have tried to make this clear in the report, but there may be places where we have not had access to important perspectives or nuances.

This has been a rapid research process, with 11 weeks between contract initiation and the presentation of key messages. Our analysis looked at where the views of different stakeholders aligned to assess our confidence in our findings, and to ensure different perspectives are presented. However—by design—VCSEs comprise a higher proportion of research input. We engaged with both KCC and VCSEs in drafting this report, but neither has been invited to respond to findings individually. We acknowledge there may be areas where our findings do not resonate with all partners.

Appendix E: Recommended reading for commissioners

This research has identified a few key documents which may be useful for commissioners as a next step in thinking about the issues of FCR and wider questions about alternative models of commissioning.

Resource	Description
Frank Villeneuve-Smith and Julian Blake, The art of the possible in public procurement, (London: HCT Group, 2016).	Briefing on the Public Contracts Regulations 2015 outlining the flexibility they provide to commissioners to achieve the outcomes they seek for their communities.
Toby Lowe, *Creating Outcomes in Complexity*, online YouTube recording, 2021.	Presentation from the Centre for Public Impact—a Human Learning Systems approach to how to commission in a way which helps people to create outcomes in their lives.
CIPFA, Unlocking Potential, Realising the role of local charities in public service delivery, 2022.	Report which considers the factors that prevent involvement of charities and voluntary organisations in the provision of public services and the triggers that may now lead authorities to think differently.
Human Learning Systems, *Plymouth Alliance for Complex Needs*, 2021.	Case study of a human learning systems approach to commissioning.
NPC, *Keeping account: A guide to charity financial analysis*, 2013.	Guide from NPC outlining charity financial models and useful guidance on charity financial analysis.

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