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Ministry of Justice

Procurement of Criminal Legal Aid Services: Financial Modelling

11 March 2014

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11 March 2014

Dear Sirs

The Provision of Consultancy Services for Crime Competition Financial Modelling (Ref 643 RM2592 (MOJ 2983-1)

In accordance with our contract and its attachments dated 30 October 2013, and extensions to that contract dated 18 December 2013 and 23 January 2014, we enclose our report on crime competition financial modelling. This final written report supersedes all previous oral, draft or interim advice, reports and presentations, and no reliance should be placed by you on any such oral, draft or interim advice, reports or presentations other than at your own risk. Our proposal dated 17 October 2013 sets out the agreed scope of our work. You should note that our findings do not constitute recommendations to you as to whether or not you should proceed with any particular course of action. The Important notice included on this page should be read in conjunction with this letter.

Our report is for the benefit and information of the Ministry of Justice only. The scope of our work for this report has been agreed by the Ministry of Justice and to the fullest extent permitted by law, we will not accept responsibility or liability to any other party (including the Ministry of Justice's legal and other professional advisers) in respect of our work or the report.

Yours faithfully,

KPMG LLP

KPMG LLP

Important notice

Our work commenced on 30 October 2013 and fieldwork has continued to 29 January 2014. We have not undertaken to update our report for events or circumstances arising after that date.

In preparing our Report, our primary sources have been Ministry of Justice internal management information, representations made to us by management of the Ministry of Justice ("the Client") and the December 2013 Otterburn Legal Consulting report titled 'Transforming Legal Aid: Next steps'. We do not accept responsibility for such information which remains the responsibility of Ministry of Justice management and Otterburn Legal Consulting. Details of our principal information sources are set out throughout and we have satisfied ourselves, so far as possible, that the information presented in our report is consistent with other information which was made available to us in the course of our work in accordance with the terms of our contract and scope as agreed with you. We have not, however, sought to establish the reliability of the sources by reference to other evidence.

This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed.

We accept no responsibility or liability for the findings or reports of legal and other professional advisers even though we may have referred to their findings and/or reports in our Report.

This Report has not been designed to be of benefit to anyone except the Client. In preparing this Report we have not taken into account the interests, needs or circumstances of anyone apart from the Client, even though we may have been aware that others might read this Report. We have prepared this report for the benefit of the Client alone.

This Report is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the Client) for any purpose or in any context. Any party other than the Client that obtains access to this Report or a copy (under the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002, through a Beneficiary's Publication Scheme or otherwise) and chooses to rely on this Report (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this Report to any party other than the Client.

In particular, and without limiting the general statement above, since we have prepared this Report for the benefit of the Client alone, this Report has not been prepared for the benefit of any other Government Department or Non-departmental Public Body nor for any other person or organisation who might have an interest in the matters discussed in this Report, including for example Ministry of Justice employees, the Trade Unions, customers of the Ministry of Justice, those who provide goods or services to the Ministry of Justice, providers of legal aid services or the Law Society.

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MoJ is developing, and has consulted on, proposals for the reform of the criminal legal aid system

The Government is committed to reducing spend across the public sector, with significant spending cuts expected of the MoJ

- By 2015/16, the Ministry of Justice budget will have been reduced by around a third since 2010, with the legal aid scheme achieving a similar reduction in funding after the reforms
- At present, legal aid has an annual cost of around £2 billion, with around £1 billion of this spent on criminal legal aid

The Government's proposals for the reform of the criminal legal aid system are intended to create a more efficient, modernised criminal legal aid market, operating at a reduced cost to the taxpayer

- The initial consultation on proposals in April 2013 elicited nearly 16,000 responses. These have been considered by MoJ and incorporated into thinking to modify initial proposals
- The MoJ concluded that the responses supported its view that the market for criminal defence services needs significant consolidation and restructuring if it is to function at a lower cost
- The key modifications to the original proposals included:
  - Inclusion of own client contracts (alongside duty provider contracts) to protect the defendant's right to choose their own legal representative
  - Removal of price competitive tendering – MoJ would now set fee rates centrally and these would apply to all providers whether on duty provider or own client contracts
  - Disaggregation of some CJS areas for duty provider contracts due to geographical constraints to create a greater number of smaller procurement areas
- A summary of the key components of the revised proposals is included on the following page

Background

Key tenets of the September 2013 proposals are retention of own client contracts, a smaller number of duty provider contracts and the introduction of fixed fee schemes

The table below describes the key elements of MoJ's September 2013 proposals

Area	Modified proposal
Type of contract	■ Defendants would be able to either select their own provider at point of request or use the duty provider. Two different types of contract would therefore be available: – Own client contracts which enable firms to continue to provide just own client work – Duty provider contracts, where firms, not individual solicitors, are awarded the work on a duty slot basis
Geography	■ For own client work, the procurement area would be England and Wales i.e. a provider would be able to operate anywhere in the country ■ For duty provider work, 62 procurement areas have been proposed based on a mixture of Criminal Justice System (CJS) areas and combined police station duty scheme areas
Number of contracts	■ For own client work, there would be no restriction on the number of contracts across England and Wales, subject to a minimum quality standard being met by providers ■ For duty provider work, the precise number of contracts per procurement area is still to be determined and is the subject of this report (see next page). Firms would be able to compete to deliver services in more than one procurement area
Contract length	■ A four year term for both own client work and duty provider work is proposed, with the option for the Government to extend the contract term by up to one year
Contract value	■ For own client work, there would be no limitation on value ■ For duty provider work, providers would be contracted to deliver an equal share of police station and magistrates' court duty slots in their procurement area, plus any follow on work in magistrates' and Crown courts. Actual value will be dependent on crime volumes, the proportion of defendants who choose to use the duty provider and the number of contracts in an area
Remuneration	■ Fixed fee schemes would be introduced for police station attendance, magistrates' court representation and Crown Court litigation (cases with less than 500 pages of prosecution evidence (PPE)) ■ For Crown Court litigation, cases with more than 500 PPE would be funded under the Litigators Graduated Fee Scheme ■ All other remuneration mechanisms would remain unchanged, although rates of pay would be reduced ■ *Note that these fee proposals are under further consideration. This report is based upon an alternative option as advised by MoJ – see page 33*

Source: MoJ, Transforming Legal Aid: Next Steps, September 2013

In the context of the modified proposals, MoJ needs to determine the number of contracts that should be let in each procurement area

The focus of this report is to provide quantified, financial analysis to inform MoJ as it considers the following question:

For each procurement area, how many contracts should be let in order to create a sustainable market at the reduced rates?

The following definitions have been agreed in relation to the key components of this question:

- *Sufficient capacity*: There are sufficient providers capable of delivering the required volume of work under the new contracts
- *Competition:* For this and at least one further competition there is competitive tension in the market
- *Viability:* Winning bidders have a business model that results in a financial performance that enables them to continue to trade in a sustainable way

We have developed a bespoke methodology that considers each element of the question. This is outlined on pages 27 to 36

- This method has been developed in conjunction with MoJ and is based on the data available
- The data available does not allow for a comprehensive assessment of individual firms under the proposals
- Instead, for reasons including commercial confidentiality, data is provided to us on an aggregated and/or anonymised basis
- The methodology requires a number of assumptions to be made to illustrate the potential impact of letting alternative numbers of contracts. These are set out in detail on pages 32 and 35

Our analysis draws upon MoJ and Legal Aid Agency data, in addition to market research commissioned by the MoJ and other stakeholders

- In particular, we have utilised data provided by Otterburn Legal Consulting as part of its "Transforming Legal Aid: Next Steps" report jointly commissioned by the Law Society of England and Wales and the Ministry of Justice
  - The Otterburn report includes qualitative survey evidence from 167 respondents, summary financial data for 157 firms and detailed interview feedback from 26 organisations
  - Whilst this is recognised to be the most comprehensive analysis of financial information on criminal legal aid providers available, it is noted to have some limitations. These are explained on page 26 of this report

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Executive Summary

Overview of market and firm analysis

The focus of this report is to inform MoJ as it considers the following question:

For each procurement area, how many contracts should be let in order to create a sustainable market at the reduced rates?

There are a number of key market characteristics which will impact on the number of duty contracts which could be let

- *Reducing market size* – MoJ spend on legal aid has fallen in the last five years as a result of lower crime volumes, changing sentencing patterns and fee reductions. Volumes are expected by MoJ to remain stable in the future, however, further fee reductions are proposed as explained in MoJ's consultation papers
- *Fragmented supplier base* – There are a large number of small providers in a market which has experienced limited consolidation activity to date. In future, achieving the 17.5% fee reduction proposed is anticipated to require market consolidation in order to access economies of scale
- *Significant differences depending on type of procurement area* – Proposed procurement areas can be broadly categorised as rural, urban or London regions. Each demonstrates different features:
  - Rural areas tend to cover larger geographic areas, with dispersed populations, a lower criminal legal aid spend per area and higher concentration of market providers
  - Urban areas tend to be more geographically concentrated, have a higher spend per area and a lower level of market concentration
  - London is the extreme of the urban areas, with the highest spend per area and the highest level of market fragmentation
- Further analysis of the market is set out on pages 13 to 17 of this report

The micro-economic position of firms varies significantly by size of firm and type of procurement area

- Of firms surveyed by Otterburn Legal Consulting, the median net margin from crime fee income was 5%, with a lower quartile of -14% and an upper quartile of 20%
- Crime fees on average accounted for 51% of total revenues of firms surveyed. However, for 36% of firms it was 100% of revenue
- *The impact of the proposed changes to fees is not expected to be evenly distributed* - while the average fee reduction of 17.5% is to be applied to all Crown Court and Magistrate Court fees, the impact of the fixed fee scheme on police station work will vary by procurement area.
- *There appears to be potential to improve efficiencies in staff costs in all areas*
  - At least 25% of firms are already at least 6% more efficient than the average in rural and urban areas, and 10% more efficient in London areas
  - There are anecdotal indications that there is latent capacity in the system as workload has declined without being matched by similar levels of staff reductions in firms
  - We understand that to date, duty solicitors have been able to attract salary premiums due to the way in which slots are currently awarded to named individuals rather than firms. As a result of the proposed change to the firms being awarded the slots, there is potential for this premium to reduce over time
- *However, the potential for significant efficiencies within overheads appears limited* - The main overhead appears to be property costs associated with offices. As some firms are locked into lease contracts, it may be difficult to achieve savings in the short term

Outputs of analysis

Our analysis has been undertaken in two parts, for which the following definitions have been developed:

- *Sufficient capacity and competition:* There are sufficient providers capable of delivering the required volume of work under the new contracts and for this and at least one further contract renewal there is competitive tension in the market
- *Viability:* Winning bidders have a business model that results in a financial performance that enables them to trade in a sustainable way after the 17.5% fee reduction

There is a trade-off between financial viability and sufficient capacity and competition

- The larger the contract size, the greater the economy of scale. Therefore fewer contracts improves the viability of successful providers
- However larger contracts mean fewer firms in each area have the scale to deliver them without market consolidation. Therefore more consolidation is required for a competitive market

This means that there is not necessarily a single answer for each area

- Instead a range is proposed within which MoJ must make a judgement around the balance between these competing aims

It is not clear to what degree the market can or will consolidate

- Based on the data available, it is possible to illustrate the extent of market consolidation needed, but not to fully assess the extent to which this level of market consolidation can be achieved

Firms' financial data is limited

- To assess the impact on the viability of firms, the Otterburn report has been our principal data source. Whilst this is recognised to be the most comprehensive and up-to-date analysis of financial information on criminal legal aid providers available, it has some limitations. These are explained on page 26 of this report

Based on the method outlined (see pages 27 to 36), 23 out of 62 proposed procurement areas have a potential range of contracts for which:

- The average staff efficiency saving required is less than 20%;
- Less than 25% of the market needs to consolidate; and
- There are at least 3 incumbent providers with capacity to deliver

For these 23 areas, key outputs are as follows (detail on page 43):

In each area:	Minimum number of contracts in range	Maximum number of contracts in range
Number of contracts	143	169
Change in average staff efficiency required among firms	15%	17%
Market consolidation required	15%	11%

30 areas required further inspection to determine a range of contracts

For these areas, key outputs are as follows (detail on pages 44 to 45):

In each area:	Minimum number of contracts in range	Maximum number of contracts in range
Number of contracts	142	146
Change in average staff efficiency required among firms	20%	20%
Market consolidation required	30%	28%

For 21 of these areas, the principle challenge was identified:

- Six areas had fewer than 3 incumbent providers with capacity to deliver
- Five areas required an improvement in average staff efficiency of more than 20%
- Ten areas required market consolidation of more than 25%

Nine areas required further consideration based on the specific local context

All 9 London areas require further consideration (see next page)

Outputs of analysis (cont.)

The London market represents over a third of the spend on duty work in England and Wales yet is a highly fragmented market

- The nine London areas have a combined legal aid spend of £124m of which £56m relates to duty contract work. On average, only 30% of fees are earned by the top 8 firms within each area. 132 London firms earn duty fees of over £100,000
- The fragmented nature of the London market means that few firms currently have sufficient capacity to deliver the size of contract needed within nine areas

For the 9 London procurement areas, the key outputs are (detail on page 46):

In each area:	Minimum number of contracts in range	Maximum number of contracts in range
Number of contracts	70	90
Change in average staff efficiency required among firms	17%	19%
Market consolidation required	55%	54%

In response to the extent of the market consolidation required, an alternative approach was explored for London in which the procurement areas were reassessed based on 32 smaller police station duty schemes

For the 32 London procurement areas, the key outputs are (detail on page 49):

In each area:	Minimum number of contracts in range	Maximum number of contracts in range
Number of contracts	147	210
Change in average staff efficiency required among firms	17%	19%
Market consolidation required	54%	49%

The London procurement areas require market consolidation of around 50% whether 9 or 32 areas are modelled. However, the market consolidation requirement is sensitive to assumptions around the number of new entrants to the market

- An alternative scenario was explored in which 4 new entrants joined each London market instead of 2 as modelled elsewhere
- For 9 areas this would mean the incumbents would need to consolidate on average 45% of the market. For 32 areas, incumbents would need to consolidate on average between 28% and 36% of the market based on the range of contracts identified
- Further consideration is required to assess whether this level of market consolidation is achievable in the context of the London market and the propensity of firms to bid in multiple areas

A judgement is required on whether to procure London as 9 areas, or as 32 areas. The points to consider are:

- The use of smaller procurement areas leads to over twice as many contracts with a smaller average contract size in London when compared to areas outside London. This can offer flexibility for firms to consider strategies appropriate to their size, including competing for multiple area contracts. 89 firms currently earn fees in more than 16 of the 32 smaller areas
- However, procuring on the 32 area basis will increase the procurement effort to evaluate 32 competitions in place of 9. In addition, firms who choose to bid in multiple areas to gain sufficient scale to be viable or to grow their businesses will be faced with a greater number of tenders to produce. The approach to evaluating bids from such firms will also need to be considered

Outputs of analysis (cont.)

Across England and Wales (excluding London) between 285 and 315 contracts are proposed with an average duty contract size of between £400,000 and £440,000

There are two approaches to the London market

- If London is procured on a 9 area basis then between 70 and 90 contracts are proposed with an average duty contract size of between £620,000 and £800,000
- If London is procured on a 32 area basis then between 147 and 210 contracts are proposed with an average duty contract size of between £270,000 and £380,000

The total for England and Wales if London is procured on a 9 area basis is between 355 and 405 contracts with an average size of £450,000 to £510,000

The total for England and Wales if London is procured on a 32 area basis is between 432 and 525 contracts with an average size of £350,000 to £420,000

Summary	Market value (year to Sept 2013) £m			Average duty contract size (£m)		Range by Inspection		Change in average staff efficiency		Consolidation required		Change in average staff efficiency		Consolidation required	
	Own	Duty	Total	min	max	min	max	min	max	min	max	min	max	min	max
Non-London total without further inspection	159	68	226	0.16	0.47	143	169	15.1%	17.0%	14.8%	11.8%	***With 4 new entrants per London area:***			
Non-London total with further inspection	80	59	139	0.18	0.42	142	146	19.6%	20.1%	29.7%	27.9%				
Non-London total	**239**	**127**	**366**	**0.44**	**0.40**	**285**	**315**	**17.2%**	**18.4%**	**21.7%**	**19.3%**				
London 9 areas (2 entrants)	68	56	124	0.80	0.62	70	90	17.2%	18.9%	55.0%	53.5%	16.9%	18.6%	45.2%	46.2%
London 32 areas (2 entrants)	68	56	124	0.38	0.27	147	210	17.0%	19.2%	53.8%	48.9%	15.4%	17.4%	28.2%	35.7%
England and Wales Total (London on 9 area basis)	**307**	**183**	**490**	**0.51**	**0.45**	**355**	**405**	**17.2%**	**18.6%**	**31.9%**	**29.8%**	**17.1%**	**18.5%**	**28.9%**	**27.5%**
England and Wales Total (London on 32 area basis)	**307**	**183**	**490**	**0.42**	**0.35**	**432**	**525**	**17.1%**	**18.7%**	**31.6%**	**28.3%**	**16.6%**	**18.1%**	**23.7%**	**24.3%**

Other considerations

A number of barriers to market consolidation exist

- There is no data available on the extent to which firms will consolidate. There is some qualitative evidence from the Otterburn report which suggests that there are significant barriers to mergers of law firms (see page 56) including:
  - Regulatory requirements
  - Relocation and redundancy costs
  - Integration costs including systems, professional fees and management time
  - Desire of independently minded firms to remain independent

Investment funding may be required in three areas

- To fund increased working capital that would arise as a result of larger contracts
- To fund the investment required to achieve the staff efficiency levels implied by the proposed contracts
  - For example, IT spend on digital technologies and virtual working could increase productivity and enable greater geographic coverage
- To fund the costs of consolidation as outlined above

We have not sought to quantify the likely size of this funding although we highlight risks to its availability

- Otterburn's survey data indicates that firms have limited cash on their balance sheets available for investment
- Other studies indicate that the market believes that it will struggle to obtain funding from lenders (see page 57)

The continued presence of competitive tension within the market over the longer term is uncertain

- The approach described requires that there are a higher number of bidders in each procurement area than are awarded contracts to ensure competitive tension
- This means that some unsuccessful bidders will need to survive in the market for four years until the next competition
- Own client work may be sufficient to support some firms but given the importance of duty provider work in enabling new client relationships, there is a risk that such work will not continue at current volumes and that some firms may choose to exit the market
- Therefore in second and subsequent procurements it is possible that the market may no longer be competitive under the same procurement terms (see page 57). This is uncertain.

Aspects of the proposals which are outside the scope of our work may have an impact on the overall assessment

- Firms unsuccessful in securing new duty provider contracts will be faced with a choice of consolidating with successful bidders, downsizing or growing their own client work
  - The impact of the proposals on unsuccessful bidders was not part of the scope of this report and has not been considered further
- Assessment of viability may include non-financial measures, such as:
  - Geographies and travel time
  - Case mix variability
  - These have been considered separately by MoJ and our approach has focussed solely on the profitability aspect of viability of contracts

This analysis was conducted over a relatively short period of time and is based on the data available, which has some limitations (see page 26)

Next steps

We recommend MoJ review each procurement area for which a range of contracts has been identified and decide on the number of contracts to let. In particular, we recommend that MoJ:

- Consider the results with reference to the assumptions used, in particular the thresholds for average staff efficiency and the extent of market consolidation required and decide upon the most appropriate number of contracts to let where a range of possible solutions is identified
- For procurement areas in which further consideration is required, MoJ should consider:
  - The capability of incumbents to grow
  - The likelihood of the procurement attracting providers from outside the area to enter the market
  - To what extent the average staff efficiency improvement required reflects the local context. This includes the extent to which the aggregated information on overheads is applicable, particularly for very small firms or single practitioners where overheads might be overstated
  - The proportion of market consolidation achievable. For example, by considering how much firm combinations are required in absolute terms
- In the process of finalising this report, we understand that MOJ have begun to consider these factors

We recommend MoJ consider the most appropriate approach to procurement within the London market

- MoJ should consider the potentially lower market consolidation requirement and increased flexibility in terms of strategies available to firms on a 32 area basis and judge this against the complexity of the procurement in which many firms will bid in multiple competitions

We further recommend that MoJ consider the impact on their bid evaluation process of firms bidding for contracts in more than one area

- This is likely to occur more frequently in the London areas. Where firms share resources such as staff and/or premises between areas, the approach to assessing capacity needs to allow for multiple concurrent bids in multiple areas. In particular the following issues should be considered:
  - The order in which areas are evaluated – does a firm winning in one area affect its chances in other competitions?
  - The extent to which shared resources are double-counted between area bids
  - The extent to which firms are required to demonstrate sufficient capacity for all concurrent bids in advance of contract award
  - The extent to which firms are required to demonstrate sufficient working capital availability commensurate with winning all concurrent bids, in advance of contract award

For all areas, we recommend MoJ consider the implications of other factors such as those set out on the previous page

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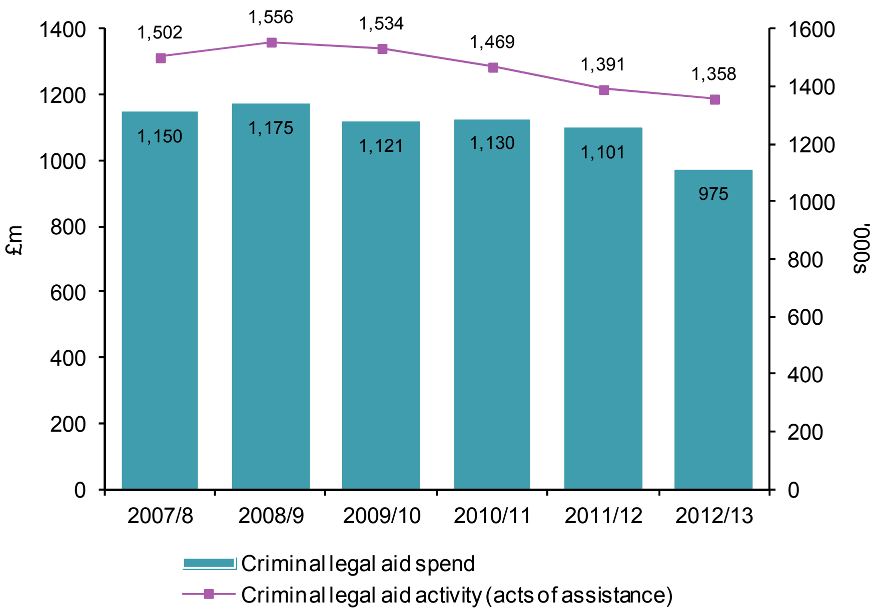
The value of the legal aid market has declined since 2008/9 as a result of falling crime volumes and reduction in fee levels

Criminal legal aid spend and workload, 2007/8-2012/13[(1)(a)]



CAGR (%)	2008/9-2012/13
Criminal legal aid spend	-3.7%
Criminal legal aid activity (acts of assistance)	-2.7%

Volumes of legal aid activity have declined over the last five years, at a CAGR (Compound Annual Growth Rate) of -2.7%

- In 2012/13, there were 1.36 million acts of assistance in England and Wales

Over the same period, the total spend by MoJ on criminal legal aid has declined at a higher CAGR of -3.7%

- This higher rate is as a result of a series of fee reductions introduced in over the period April 2010 to April 2012

The impact of these fee reductions is demonstrated by the fall in total criminal legal aid spend from £1.13 billion in 2010/11 to £0.98 billion in 2012/13, a reduction of 13.7%

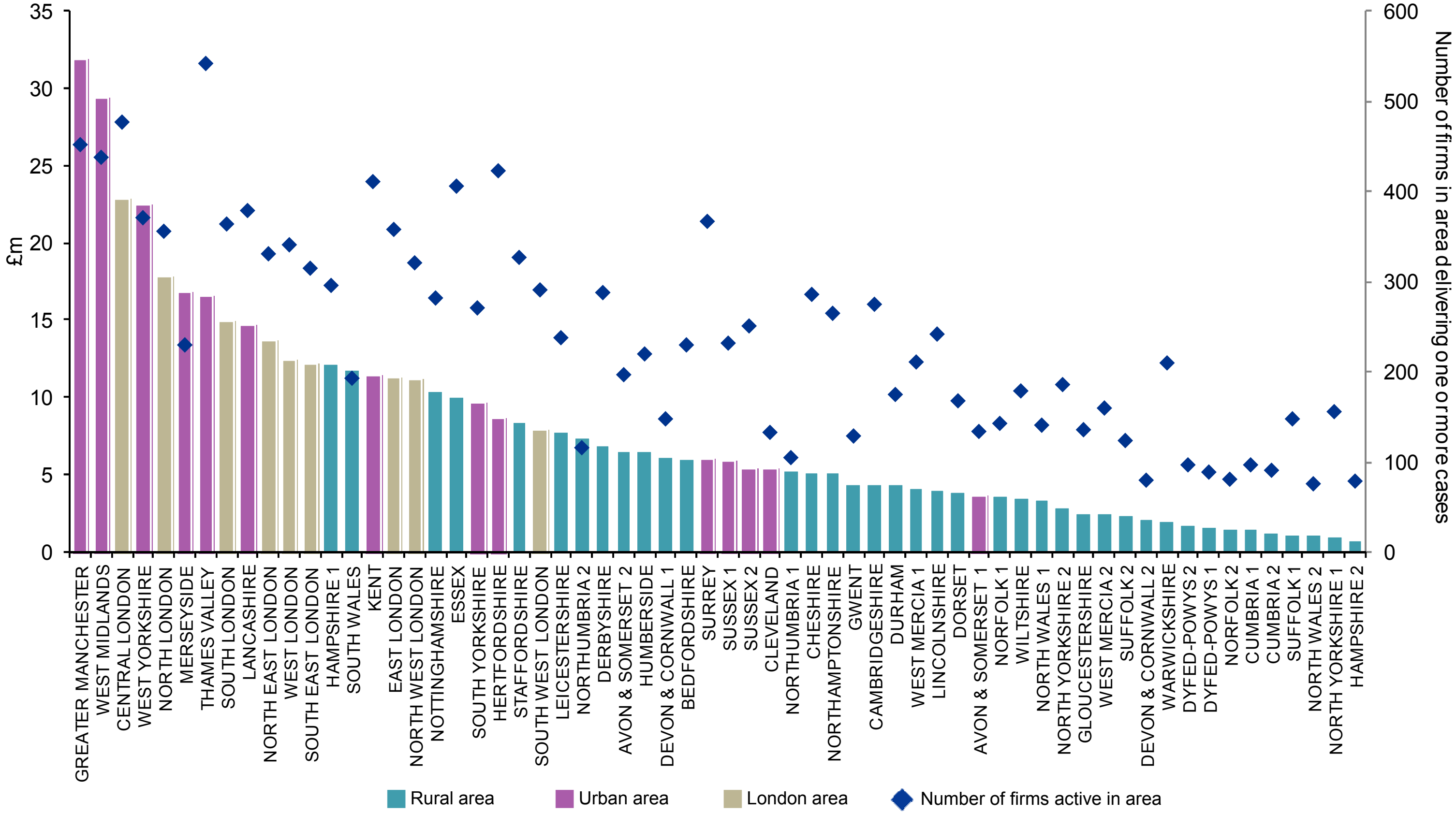
- The number of acts of assistance has fallen by 7.6% over this period. The full impact of these changes on providers is understood to have not yet been fully demonstrated in financial results

Source: (1) MoJ, Legal Aid Statistics in England and Wales, Legal Services Commission, 2012-2013, published 25 June 2013

Note: (a) Includes all spend on criminal legal aid services

Criminal legal aid spend is highest in the London and urban procurement areas

Criminal legal aid spend and number of firms providing services, by proposed procurement area, 12 months to Sept. 2013[(1)(a)(b)]



Source: (1) MoJ/LAA spend data, 12 months to September 2013

Note: (a) Spend data excludes disbursements, VAT, Very High Cost Cases, Crown Court Advocacy, Prison Law cases, The Defence Solicitor Call Centre and Criminal Defence Direct. Spend with MoD, HMRC and the British Transport Police is also excluded.

(b) MoJ analysis has mapped spend to procurement areas. For allocation purposes, cases which are heard in the courts of a CJS region are assumed to have started in a police station within the same CJS region. For procurement areas which are below the CJS region, current spend in the area is estimated by applying the proportion of duty / own client work a firm undertakes in the relevant police station scheme area, to the total Magistrates' Court and Crown Court work a firm undertakes within the CJS region. This is then added to current police station spend in the procurement area.

(c) Areas have been categorised as rural, urban and London based on the classification given by Otterburn Legal Consulting in its November 2013 report. This is summarised in Appendix 1

The criminal legal aid spend on police station, magistrates' courts and Crown Court work in the proposed procurement areas in the 12 months to Sept. 2013 was £490m[(a)]

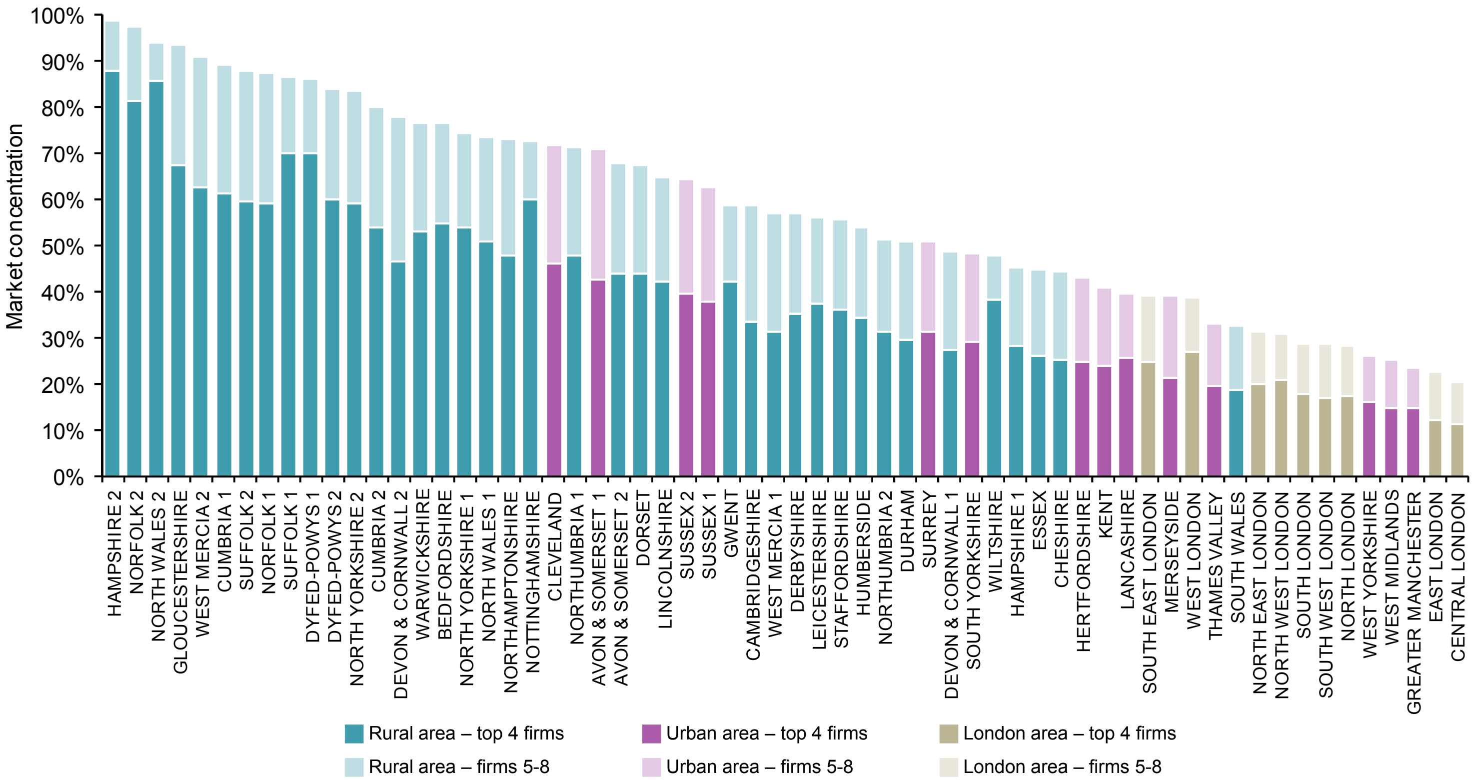
- £178m (36%) was spent in 39 rural areas, compared to £188m (38%) spent in 14 urban areas and £124m (26%) in 9 London areas
- This results in an average spend per area of £4.6m in rural areas compared to £13.4m and £13.8m in urban areas and London respectively

The number of firms active in each area ranges from 542 in Thames Valley to 79 in Hampshire 2 (Isle of Wight)

- The number of firms appears to be related to the spend per area, with high spends in London and urban areas broadly aligning to areas with higher numbers of active firms
- Note that this chart considers the number of firms active in each procurement area on an area by area basis. The total number of firms in the market (just under 1,600) is significantly less than the total of figures shown due to firms operating in more than one area

The market is fragmented, although the extent of fragmentation varies by type of proposed procurement area

Market concentration: Revenue of top 4 and top 8 firms as a percentage of total market spend, by proposed procurement area, 12 months to Sept. 2013(1)(a)(b)



Source: (1) MoJ/LAA spend data, 12 months to September 2013

Note: (a) Spend data excludes disbursements, VAT, Very High Cost Cases, Crown Court Advocacy, Prison Law cases, The Defence Solicitor Call Centre and Criminal Defence Direct. Spend with MoD, HMRC and the British Transport Police is also excluded.

(b) MoJ analysis has mapped spend to procurement areas. For allocation purposes, cases which are heard in the courts of a CJS region are assumed to have started in a police station within the same CJS region. For procurement areas which are below the CJS region, current spend in the area is estimated by applying the proportion of duty / own client work a firm undertakes in the relevant police station scheme area, to the total Magistrates' Court and Crown Court work a firm undertakes within the CJS region. This is then added to current police station spend in the procurement area.

(c) Areas have been categorised as rural, urban and London based on the classification given by Otterburn Legal Consulting in its November 2013 report. This is summarised in Appendix 1

At an aggregate level, the current criminal legal aid market is highly fragmented

- The Legal Aid Agency contracts with over 1,600 individual organisations to deliver services under the 2010 Standard Crime Contract

However, by proposed procurement area, market concentration varies significantly

- Rural areas tend to be the most concentrated, with the top eight providers on average accounting for 70% of the market
- Urban areas are currently less concentrated, with the top eight providers on average accounting for 47% of the market
- London areas are the most fragmented, with on average only 30% of activity provided by the top eight firms in an area
- There are a number of reasons suggested for the increased concentration in rural markets including smaller markets in terms of spend, resulting in lower economies of scale, and the distances and travel times involved leading to local concentrations of provision around courts

Key market characteristics impact on the number of duty provider contracts that could be let

- ***Reducing market size*** – MoJ spend on legal aid has fallen in the last five years as a result of lower crime volumes, changing sentencing patterns and fee reductions. Volumes are expected to remain stable in the future, however, further fee reductions are proposed as explained in MoJ's consultation papers
- ***Fragmented supplier base*** – There are a large number of small providers in a market which has experienced limited consolidation activity to date. In future, achieving the 17.5% fee reduction proposed is anticipated to require market consolidation in order to achieve economies of scale
- ***Significant differences depending on type of area*** – Proposed procurement areas can be broadly categorised as rural, urban or London regions. Each demonstrates different features:
  - Rural areas tend to cover larger geographic areas, with dispersed populations, a lower criminal legal aid spend per area and higher concentration of market providers (though not necessarily larger firms)
  - Urban areas tend to be more geographically concentrated, have a higher spend per area and a lower level of market concentration
  - London is the extreme of the urban areas, with the highest spend per area and the highest level of market fragmentation

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It is important to understand the micro economic position of a typical firm in each type of area

The differing market dynamics across areas and the varied level of fee reduction by area as a result of MoJ's national fixed fee proposals mean that it is important to understand the financials of a typical firm in each type of procurement area

- The following pages analyse the current financial performance of typical firms in rural, urban and London areas
- The figures discussed relate to total crime activities i.e. they include all criminal legal aid work (both duty work and own client) and also private client crime work
- The data is drawn from the recent survey of criminal legal aid firms conducted by Otterburn Legal Consulting. This has a number of limitations, which are explained on page 26
- Disaggregation on a more in depth area by area basis was not possible based on the data collected due to sample size. As a result, the analysis can only represent a typical firm's financial performance against which the performance of individual firms may differ

Assessment of firms

Rural firms with 6-12 solicitors generate the lowest revenue per qualified solicitor among rural firms yet attain the highest net profit margin

Rural firms analysed by no. of crime solicitors

P&L (£m)	1 - 5 Total	1 - 5 Average	6 - 12 Total	6 - 12 Average	13+ Total	13+ Average	Overall Total	Overall Average
Crime fees	9.6	0.3	4.8	0.5	4.3	1.4	18.6	0.4
Staff costs	(6.1)	(0.2)	(3.2)	(0.4)	(3.6)	(1.2)	(12.9)	(0.3)
Staff costs / revenue	*(63.4%)*		*(66.9%)*		*(84.1%)*		*(69.1%)*	
Gross profit	3.5	0.1	1.6	0.2	0.7	0.2	5.8	0.1
Overheads	(3.2)	(0.1)	(1.3)	(0.1)	(0.9)	(0.3)	(5.4)	(0.1)
Overheads / revenue	*(33.5%)*		*(26.9%)*		*(21.9%)*		*(29.2%)*	
Net profit	**0.3**	**0.0**	**0.3**	**0.0**	**(0.3)**	**(0.1)**	**0.3**	**0.0**
%	*3.0%*	*3.0%*	*6.2%*	*6.2%*	*(6.0%)*	*(6.0%)*	*1.7%*	*1.7%*
Memo								
Number of firms	33		9		3		45	
Equity partners	41		26		8		75	

Rural firms analysed by no. of crime solicitors

KPIs (no.)	1 - 5 Total	6 - 12 Total	13+ Total	Overall Total
Qualified solicitors	114	69	53	235
Unqualified solicitors	27	11	6	44
Other staff	55	37	29	121
Total headcount	**196**	**117**	**88**	**401**
Memo (£'000)				
Revenue / qual. sol.	84.0	69.4	81.1	79.1
Staff cost / head	(30.9)	(27.2)	(41.1)	(32.1)

Overheads as a proportion of revenue are smaller among larger firms

Staff cost per head is lowest among mid-sized firms

Rural firms sampled with 1 - 12 crime solicitors are currently profitable

- The Otterburn data covered a sample of 45 firms totalling crime fees of £18.6m attaining an average net profit margin of 1.7%
- Firms with 5 or fewer crime solicitors have average crime fees of £0.3m and an average net profit margin of 3.0%
- Firms with 6 – 12 crime solicitors have average crime fees of £0.5m and an average net profit margin of 6.2%
- Firms with 13 or more crime solicitors have average crime fees of £1.4m and an average net loss of 6.0%
- The lack of profitability among larger firms appears to be counter-intuitive as greater economies of scale may be expected. Indeed, overheads as a percentage of revenue are lower among larger firms
- The cost of staff among higher firms represents 84% of revenues, higher than small and mid-sized firms. A potential cause for this is excess staff capacity, which means that additional volume and value of work could be delivered without increasing staff numbers. The cost per head is also highest among larger firms
- It is important to note that the number of larger firms in the sample is just three and caution should be applied to giving too much weight to this data point

Source: 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting, KPMG analysis

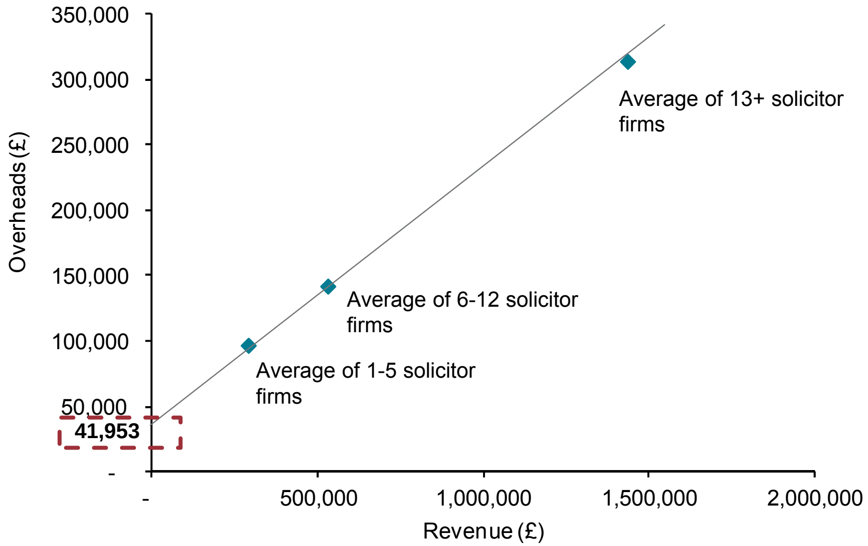
Rural firms sampled incur staff costs equal to 69% of revenue with the lower quartile on cost of 1-5 solicitor firms achieving a ratio of 54%

Analysis of staff costs

Rural: staff costs as % of revenue

	1-5	6-12	13+	Overall
Sample size	33	9	3	45
Staff costs/ Revenue	63.4%	66.9%	84.1%	69.1%
Quartiles				
Lower quartile	54.2%	62.2%	70.7%	
Median	64.0%	66.6%	75.1%	
Upper quartile	81.2%	77.0%	111.5%	
Lower quartile / mean	85%	93%	84%	

Analysis of overheads for the average firm in each size bracket



For rural firms sampled, average staff costs are 69.1% of revenue

- Firms with 1-5 crime solicitors have the lowest ratio of staff costs to revenue at 63.4% with the average for rural firms being 69.1%. Firms with 13 or more solicitors have a ratio of 84.1% but we note that this is based on a sample size of just three firms
- The spread of staff costs between individual firms within each category is broad - within 1-5 solicitor the lower quartile have a staff cost:revenue ratio of 54.2% whereas the upper quartile achieves a ratio of 81.2%
- Within each category, comparing the lower quartile ratio with the average, it can be seen that the lower quartile (i.e. The 25% of firms with the lowest staff cost ratio) have a ratio at least 7% lower than the average ratio

Overheads are partly fixed and appear to increase in line with revenue at 19% for rural firms sampled

- We analysed the overheads based on the average firm size for each category calculated from Otterburn data
- Based on our analysis, rural firms incur a minimum level of overheads of £41,953 following which average overheads per size category increase with revenue at a rate of 19%
- We note that this relationship is based on aggregated samples and would not represent the fixed/variable cost position of any individual firm. Indeed, we would expect costs to vary, particularly among the smallest category of firms

Source: 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting, KPMG analysis

Assessment of firms

Urban firms sampled with 6 or more solicitors have a profit margin in excess of 8%

Urban firms analysed by no. of crime solicitors

P&L (£m)	1 - 5 Total	1 - 5 Average	6 - 12 Total	6 - 12 Average	13+ Total	13+ Average	Overall Total	Overall Average
Crime fees	14.4	0.3	29.0	0.9	40.4	3.4	83.8	1.0
Staff costs	(11.0)	(0.3)	(20.2)	(0.7)	(29.7)	(2.5)	(60.9)	(0.7)
Staff costs / revenue	*(76.5%)*		*(69.6%)*		*(73.6%)*		*(72.7%)*	
Gross profit	3.4	0.1	8.8	0.3	10.7	0.9	22.9	0.3
Overheads	(4.1)	(0.1)	(6.4)	(0.2)	(7.0)	(0.6)	(17.5)	(0.2)
Overheads / revenue	*(28.3%)*		*(22.1%)*		*(17.4%)*		*(20.9%)*	
Net profit	**(0.7)**	**(0.0)**	**2.4**	**0.1**	**3.6**	**0.3**	**5.3**	**0.1**
Net margin %	*(4.8%)*	*(4.8%)*	*8.3%*	*8.3%*	*8.9%*	*8.9%*	*6.3%*	*6.3%*
Memo								
Number of firms	42		31		12		85	
Equity partners	71		80		45		196	

Overheads as a proportion of revenue are smaller among larger firms

Urban firms analysed by no. of crime solicitors

KPIs (no.)	1 - 5 Total	6 - 12 Total	13+ Total	Overall Total
Qualified solicitors	144	288	397	829
Unqualified solicitors	41	90	139	269
Other staff	87	210	152	450
Total headcount	**272**	**588**	**688**	**1,548**
Memo (£'000)				
Revenue / qual. sol.	100.2	100.6	101.8	101.1
Staff cost / head	(40.6)	(34.3)	(43.2)	(39.4)

Staff cost per head is lowest among mid-sized firms

Urban firms sampled with 5 or fewer solicitors are currently not profitable whereas larger firms have a net profit margin in excess of 8%

- The Otterburn data covered a sample of 85 firms with total crime fees of £83.8m attaining an average net profit margin of 6.3%
- Firms with 5 or fewer crime solicitors have average crime fees of £0.3m and an average net loss of (4.8%)
- Firms with 6 - 12 crime solicitors have average crime fees of £0.9m and an average net profit margin of 8.3%
- Based on a sample of 12 firms, firms with 13 or more crime solicitors have average crime fees of £3.4m and an average net profit margin of 8.9%
- In urban firms, as in rural firms, staff cost per head is lowest among mid-sized firms. Revenue per qualified solicitor is similar for all sizes of firm
- Overheads as a proportion of revenues are lower for larger firms, and are lower in all size categories than in rural firms

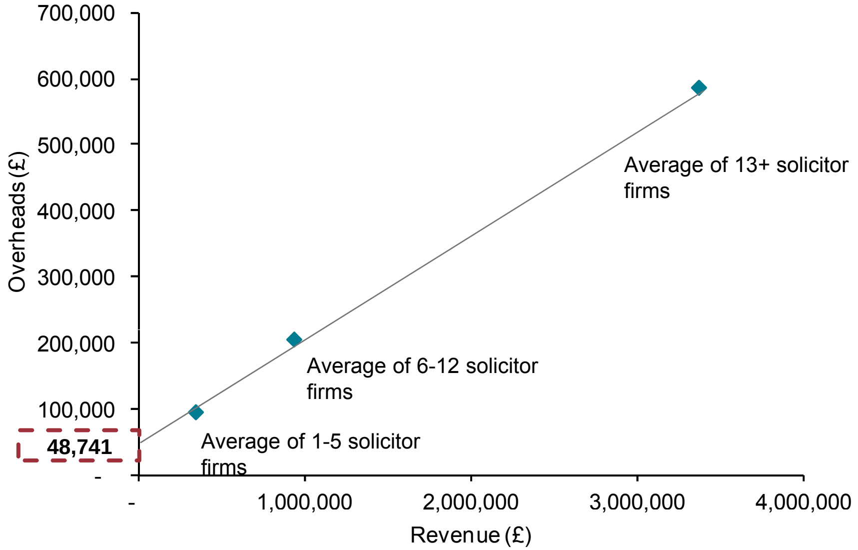
Source: 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting, KPMG analysis

Urban firms sampled incur average staff costs equal to 73% of revenue with the lower quartile on cost of 1-5 solicitor firms achieving a ratio of 51%

Analysis of staff costs

Urban: staff costs as % of revenue	1-5	6-12	13+	Overall
Sample size	42	31	12	85
Staff costs/ Revenue	76.5%	69.6%	73.6%	72.7%
Quartiles				
Lower quartile	50.9%	56.2%	69.4%	
Median	69.9%	66.9%	74.5%	
Upper quartile	80.9%	73.5%	80.3%	
Lower quartile / mean	67%	81%	94%	

Analysis of overheads for the average firm in each size bracket



For urban firms sampled, average staff costs are 72.7% of revenue

- Firms with 6-12 crime solicitors have the lowest ratio of staff costs to revenue at 69.6% with the average for urban firms being 72.7%
- Based on the quartile information provided by Otterburn, it can be seen that 1-5 solicitor firms have a greater spread of data with the lower quartile achieving a ratio of 50.9% whereas the upper quartile achieves a ratio of 80.9%
- The spread of staff costs between individual firms within each category is broadest among small and mid-sized firms – for 1-5 solicitor firms, staff costs are 50.9% of revenue for lower quartile and 80.9% at upper quartile
- Within each category, comparing the lower quartile ratio with the average, it can be seen that the lower quartile (i.e. The 25% of firms with the lowest staff cost ratio) have a ratio at least 19% lower than the average ratio for firms with fewer than 13 solicitors
- For larger firm, the effect is not as pronounced (6%) but indicates that some efficiency/ productivity may be possible if revenues were to grow

Overheads are partly fixed and increase in line with revenue at 16% for urban firms sampled

- We analysed the overheads based on the average firm size calculated from Otterburn data
- Based on our analysis, urban firms incur a minimum level of overheads of £48,741 following which average overheads per size category increase with revenue at a rate of 16%
- We note that this relationship is based on aggregated samples and would not represent the fixed/variable cost position of any individual firm. Indeed, we would expect costs to vary, particularly among the smallest category of firms

Source: 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting, KPMG analysis

Assessment of firms

For London firms sampled, only those with 13 or more solicitors are profitable

London firms analysed by no. of crime solicitors

	1 - 5		6 - 12		13+		Overall	
P&L (£m)	**Total**	**Average**	**Total**	**Average**	**Total**	**Average**	**Total**	**Average**
Crime fees	3.0	0.1	3.8	0.5	28.0	2.5	34.8	1.3
Staff costs	(2.2)	(0.1)	(3.2)	(0.4)	(19.6)	(1.8)	(25.1)	(0.9)
Staff costs / revenue	*(74.5%)*		*(85.0%)*		*(70.1%)*		*(72.1%)*	
Gross profit	0.8	0.0	0.6	0.1	8.4	0.8	9.7	0.4
Overheads	(0.9)	(0.0)	(0.9)	(0.1)	(5.5)	(0.5)	(7.4)	(0.3)
Overheads / revenue	*(30.9%)*		*(24.9%)*		*(19.6%)*		*(21.1%)*	
Net profit	**(0.2)**	**(0.0)**	**(0.4)**	**(0.0)**	**2.9**	**0.3**	**2.4**	**0.1**
%	*(5.4%)*	*(5.4%)*	*(9.9%)*	*(9.9%)*	*10.3%*	*10.3%*	*6.8%*	*6.8%*
Memo								
Number of firms	8		8		11		27	
Equity partners	10		24		21		55	

London firms analysed by no. of crime solicitors

	1 - 5	6 - 12	13+	Overall
KPIs (no.)	**Total**	**Total**	**Total**	**Total**
Qualified solicitors	36	76	293	405
Unqualified solicitors	10	5	64	79
Other staff	16	11	83	110
Total headcount	**62**	**92**	**440**	**594**
Memo (£'000)				
Revenue / qual. sol.	82.9	49.7	95.6	85.9
Staff cost / head	(36.2)	(34.9)	(44.7)	(42.3)

Staff cost per head is lower than other firms yet firms are not profitable which is partly explained by lower revenue per qualified solicitor

London firms sampled with 1 - 12 crime solicitors are currently not profitable whereas those with 13 or more crime solicitors are profitable

- The Otterburn data covered a sample of 27 firms totalling crime fees of £34.7m attaining an average net profit margin of 6.8%
- Firms with 5 or fewer crime solicitors have average crime fees of £0.1m and an average net profit margin of (5.4%)
- Firms with 6 - 12 crime solicitors have average crime fees of £0.5m and an average net profit margin of (9.9%)
- Firms with 13 or more crime solicitors have average crime fees of £2.5m and an average net profit margin of 10.3%
- Despite mid-sized firms having the lowest average cost per head, staff costs as a proportion of revenues are higher than other categories at 85.0%
- The revenue per qualified solicitor is lowest for mid-sized firms. A potential cause for this is excess staff capacity, which means that additional volume and value of work could be delivered without increasing staff numbers

Source: 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting, KPMG analysis

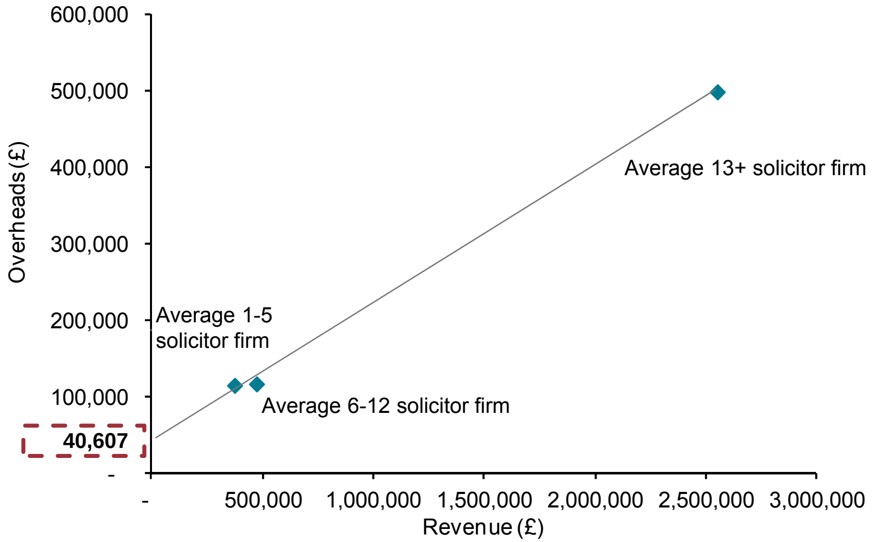
The lower quartile on cost of firms sampled achieve a ratio of staff costs to revenue that is at least 10% lower than the average

Analysis of staff costs

London: staff costs as % of revenue

	1-5	6-12	13+	Overall
Sample size	8	8	11	27
Staff costs/ Revenue	74.5%	85.0%	70.1%	72.1%
Quartiles				
Lower quartile	66.8%	75.7%	62.0%	
Median	75.9%	86.8%	70.8%	
Upper quartile	83.0%	94.4%	81.1%	
Lower quartile / mean	90%	89%	88%	

Analysis of overheads for the average firm in each size bracket



For London firms sampled, average staff costs are 72.1% of revenue

- Firms with 13+ crime solicitors have the lowest ratio of staff costs to revenue at 70.1% with the average for London firms being 72.1%
- The Otterburn data suggests that 13+ solicitor firms have a greater spread of data with the lower quartile achieving a ratio of 62.0% whereas the upper quartile achieves a ratio of 81.1%
- Within each category, comparing the lower quartile ratio with the average, it can be seen that the lower quartile (i.e. the 25% of firms with the lowest staff cost ratio) have a ratio at least 10% lower than the average ratio

Overheads are partly fixed and increase in line with revenue at 18% for London firms sampled

- We analysed the overheads based on the average firm size calculated from Otterburn data
- Based on our analysis, London firms incur a minimum level of overheads of £40,607 following which average overheads per size category increase with revenue at a rate of 18%
- We note that this relationship is based on aggregated samples and would not represent the fixed/variable cost position of any individual firm. Indeed, we would expect costs to vary, particularly among the smallest category of firms

Source: 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting, KPMG analysis

Financial data limitations

The financial data provided by Otterburn and used in the analysis has the following limitations:

- **Potential self-selection bias:** The data was collected via a survey in which firms were invited to respond. Only those firms that chose to respond have their results included in the analysis. There is a risk that this may result in an unrepresentative sample, particularly if those that are adversely affected by the MoJ proposals were more inclined to respond
- **Limited sample size:** Of the 167 respondents to the survey, 10 did not provide complete financial information and therefore the sample size was 157. This is slightly less than 10% of the 1,599 firms undertaking criminal legal aid work. Findings derived from sample sizes of less than 20 are not generally considered statistically significant. The implication of this on this work is that findings at the total rural, urban and London levels have been used rather than also analysing by firm size within analysis of procurement areas

Sample size

	1-5	6-12	13+	Total
Rural	33	9	3	45
Urban	42	31	12	85
London	8	8	11	27
Total	**83**	**48**	**26**	**157**

- **Aggregated data:** The data received from Otterburn has been provided at the aggregate level of firms size and area type. KPMG has not had access to raw data and therefore have been unable to test the distribution of the sample to identify whether individual firms are materially skewing the results that have been derived
- **Annualised estimates:** The data received from Otterburn is based on annualised estimates provided by firms based on their performance to date in the current financial year. This means that it may not be representative of a typical full year of activity, that it has not been subject to any audit processes and also that the impact of recent fee cuts may not be fully reflected
- **Cost structures and excess capacity:** It is not possible from the data collected to make an assessment of whether firms have taken management action to align their cost base for reduced volumes of work or whether there may be excess capacity in the system. It is possible that firms may not have adjusted their cost structures for a number of reasons including a desire to understand the full implications of MoJ's proposals before making an informed decision
- **Very small firms:** The aggregated data provided is grouped for firms with 1-5 solicitors. For very small partnerships, the aggregated data may not be representative of their financial structure. In particular, the level of fixed cost/overhead may well be minimal for sole practitioners.
- **Multiple region operations:** We do not have the detailed underlying analysis to understand whether firms that have responded operate across a number of regions. We have therefore assumed that the average profitability analysis and relationships between revenues and costs are representative of single region operations

Contents

There is a trade-off between viability and capacity

The method described in this section has been developed based upon the data available to consider the question:

For each procurement area, how many contracts should be let in order to create a sustainable market at the reduced rates?

- There is a tension between the aims of sufficient capacity, competition and viability. The larger the contract, the more profitable a winning firm will be through economies of scale. Therefore, fewer contracts improves the viability of winning providers
- However, the larger the contracts, the fewer the number of firms in each procurement area who have the capacity to be able to deliver them without market consolidation. If there are sufficient firms of scale, competitive tension requires there to be more providers capable of delivering the contracts than there are contracts to let. Therefore, lower value contracts, i.e. a higher number of contracts, means less market consolidation is required
- In most markets, some degree of market consolidation is required for there to be enough providers who have sufficient capacity. The extent of the market consolidation required forms the basis of the **'capacity challenge'**
- In most markets, firms need to improve staff efficiency to remain financially viable at the reduced rates. The extent of this efficiency requirement forms the basis of the **'viability challenge'**
- The method sets out thresholds for both viability and capacity and describes the range of number of contracts that are within these thresholds. Where the ranges for viability and capacity overlap, the 'inner range' is the range of number of contracts which are within thresholds for both challenges
- Where the ranges do not overlap, the procurement area requires further investigation. This involves inspecting the model to identify the range of contracts which provides the least challenge for viability and capacity. The level of challenge is then presented for further consideration as to its achievability in the context of the specific procurement area concerned
- Where there is an inner range, the relationship between capacity and viability is charted to understand the relative benefit offered by each solution
- For example, an option which lets more contracts would tend to reduce viability of winning firms. If this option did not lead to a reduced requirement for the market to consolidate then there would be no benefit gained from the reduction in viability. Within the definitions of capacity and viability used in this method, this option would not improve the viability of firms or reduce the amount of consolidation required and would therefore be of less benefit
- If letting fewer contacts increased the capacity challenge but did not materially improve viability then, again, this option was considered to be of less benefit
- By inspecting the range of potential options and eliminating those which did not improve either viability or capacity challenges, the range of possible contracts was reduced to those options where a genuine judgement is required on firm viability or the risks posed by the extent of market consolidation. Within the output of the analysis this is termed the 'inspected range'

Definitions

- The term **'incumbent'** refers to providers who are active within a procurement area based upon their demonstrated legal aid revenues (i.e. amounts earned in the year to September 2013)
- The term **"incumbent of scale"** refers to incumbents who would have sufficient capacity to fulfil a duty contract of a given size without the need for inorganic growth such as acquisition
- The term **"bidder"** describes firms who bid for contracts in the procurement area. Bidders may be incumbents or new entrants
- The term **"bidder of scale"** refers to a bidder who, *at the time of bidding*, would have sufficient capacity to fulfil a duty contract of a given size. These could be new entrants already at scale who have capacity outside the procurement area, incumbents of scale and/or bidders (new entrants or incumbents) who are currently not of scale but who grow through consolidation between now and the time of the bid

Method
Overview

The method described below has been developed in conjunction with MoJ based on the data available

Assess market capacity challenge

The analysis considered how the number of contracts required in each area aligned with incumbents' capacity to manage proposed volumes and the requirement for competition in the bidding process

Output: Range of contracts which were within capacity thresholds and for which there would be sufficient incumbents of scale. See more on page 30

Assess firm viability challenge

To assess firm viability, the analysis focussed on profitability to consider how many firms may be viable after the proposed fee reductions and assuming they won a new duty contract

- Data from the Otterburn survey was analysed to determine relationships between revenues and costs to develop an average projected P&L

Output: Range of contracts which were within viability thresholds i.e. for which contracts would be of sufficient size for winning firms to be profitable. See more on page 33

First pass outputs:

Procurement areas with an inspected range of contract numbers for which both viability and capacity challenges were within thresholds (reported on page 43)

Procurement areas which after further inspection produced an inspected range (reported on page 44)

Procurement areas for which the challenge on one or more thresholds suggested that further analysis should be undertaken (reported on page 45) and which underwent 'second pass analysis'

Re-analyse capacity and viability challenges for alternative procurement area structure

Analysis was undertaken at the smaller police station duty scheme level within those procurement areas where no inspected range was found on first pass (this occurred in London areas)

Output: Range of contracts and associated capacity and viability challenge requirements at police station scheme level

Re-analyse capacity and viability challenges for alternative competition assumptions

For second pass markets, an alternative assumption around the number of new entrants was used and the challenges reassessed at both procurement area level and police station duty scheme level

Output: Capacity challenge for the inspected range identified at both procurement area and police station duty scheme levels

Second pass outputs:

Police station duty schemes with an inspected range of contract numbers and the viability and capacity challenges faced (reported on page 49)

Alternative view of capacity challenge for the inspected range of areas which underwent second pass analysis (reported on pages 50 and 51)

Method
Market capacity

The method applied to determine the number of contracts required for sustainable, competitive markets is based on the steps below. It used data provided by MoJ which showed the own client and duty provider revenues for the 12 months to Sept 2013 for all firms by office code and by procurement area

Note that we have only had access to this data on an anonymous basis, using unique firm and office identification codes

Step	Definition
1. Focus on top 25 firms	We analysed the data by procurement area for the top 25 firms on a total revenue basis, classifying the remaining firms as "Rest"
2. Estimate total market capacity required to deliver duty work	For each area we determined the total market capacity required to deliver duty work using revenues for the 12 months to Sept 2013 as a proxy for capacity
3. Determine capacity for each of top 25 firms	For each provider in the top 25, we determined its demonstrated capacity using both duty revenues and a proportion of own client revenues (also for the 12 months to Sept 2013). We illustrated the increased capacity potential of each firm using assumptions around the extent to which latent capacity exists and to which capacity growth from external recruitment could be achieved
4. Assess capacity against different number of contracts	For each 'n' no. of contracts (4,5,6,7…25), the total market capacity requirement for duty work was divided by 'n' contracts to derive the duty work contract size threshold. We counted the number of providers who have capacity to achieve this threshold (incumbents of scale). A minimum of **3 incumbents of scale** were required
5. If consolidation required, determine range of contracts for which consolidation is less than the threshold	If incumbent bidders had a capacity shortfall, we then calculated the proportion of capacity from other providers in the market that would need to be consolidated. We set a **market consolidation threshold of 25%** and determined a range of 'n' contracts where there was sufficient capacity within the market with less than 25% consolidation required
6. Test whether any firm suffers a reduction in duty provider work as a result of proposed number of contracts	By inspection, we sought to identify whether any firm could lose duty work as a result of the proposed range of contracts. The current split between duty provider and own client work has been derived by MoJ analysis (see page 32). Therefore, this test is only illustrative

To ensure that there was sufficient competition in the process, we made some assumptions regarding the likely number of genuine bids

Step	Number
Illustrative no. of contracts	6
Minimum assumed ratio of 2 bidders for each contract	6 x 2 =12
Assume 2 of these bidders are new entrants to the area	12 – 2 = 10
Assume 75% of remaining bidders are of scale	10 x 75% = 8

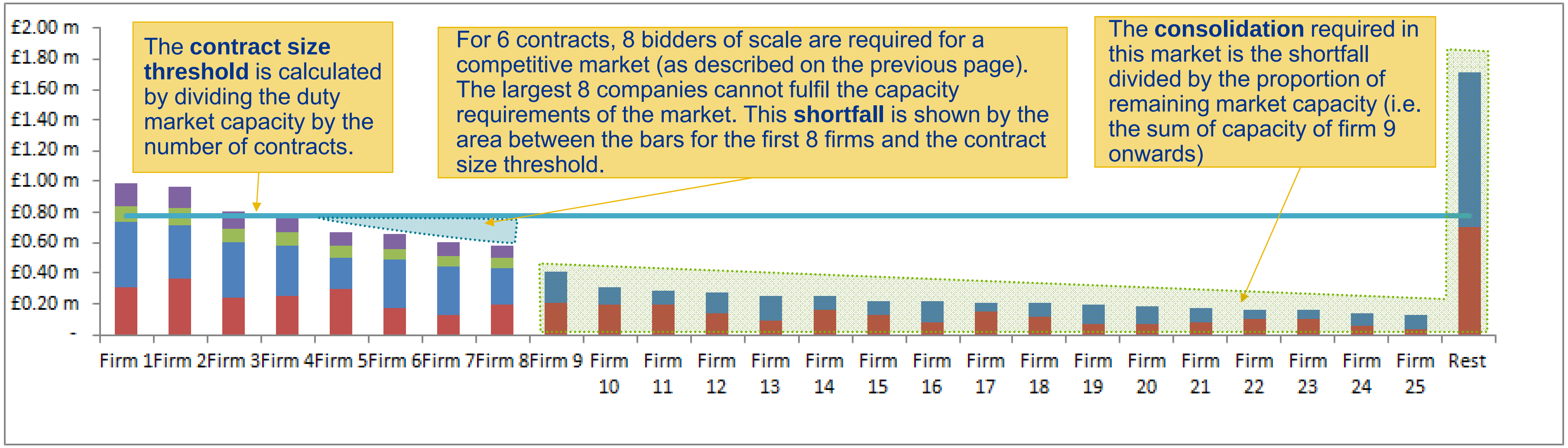
In this example, in order to provide a **competitive market**, 6 contracts would require 8 incumbents to become bidders of scale

Method

Market capacity - worked example

The example below considers the approach to a fragmented market where a range of contracts that meet the capacity challenge can be identified

- The **capacity** of each firm is represented by their bar in the chart below and considers the following factors.
  - 12m to Sept. 2013 duty value
  - 12m to Sept. 2013 own client value x 50% (see page 32)
  - Improved productivity growth and internal reallocation of 15%: this assumes some latent capacity exists and/or that a proportion of staff could be transferred from other work
  - Organic growth of 20%: this assumes that each firm can grow by, for example, recruitment
- The total duty market capacity was divided by the number of contracts between 4 and 25 to determine the size of a contract under each scenario. This is stated as a contract size threshold.
- A minimum of **three incumbents of scale** are assumed to be required i.e. 3 firms who have sufficient capacity to meet the contract size before market consolidation



- If the illustrative procurement area above was set to have 6 contracts then 10.8% **market consolidation** is required.
- Our capacity analysis currently assumes a **threshold of 25% consolidation requirement**. If under all scenarios for number of contracts there is no contract range in which the consolidation requirement is less than the threshold, the procurement area is considered to require further investigation

Method

Our market capacity method relies on a number of principles and assumptions

Principle / Assumption	Definition	Source
No. of procurement areas	■ 62 procurement areas as per MoJ September 2013 consultation proposals	Discussions with MoJ
Minimum no. of contracts due to conflicts of interest	■ MoJ have specified that the minimum number of contracts per procurement area is four ■ This is based on MoJ analysis that demonstrates that 99.83% of police station cases and 99.95% of Crown Court cases have four or fewer defendants	MoJ consultation paper, "Transforming Legal Aid"
Volumes	■ Whilst MoJ recognise that volumes may fluctuate going forwards, for this analysis it has been assumed that volumes remain constant at 2012/13 levels	Discussions with MoJ
Duty and own client work is interchangeable. 50% of OC capacity considered available for duty work	■ The capacity analysis assumes that duty and own client work is interchangeable on the basis that the fee structure and work requirements are the same. However, some firms may prefer to consolidate capacity from other providers before using existing own client capacity to fulfil duty contracts ■ The method applied assumes 50% of existing own client capacity would be available to deliver new duty provider contracts	Discussions with MoJ
Duty and own client split of magistrates' and crown court work	■ MoJ analysis has mapped court work spend to firms and procurement areas. For allocation purposes, cases heard in the courts of a CJS region are assumed to have started in a police station within the same CJS region ■ For procurement areas which are below the CJS region, current firm capacity in the area is estimated by applying the proportion of duty / own client work a firm undertakes in the relevant police station scheme area, to the total Magistrates' Court and Crown Court work a firm undertakes within the CJS region. This is then added to current police station capacity in the procurement area.	Analysis provided by MoJ
Existing latent capacity and staff reallocation	■ A 15% improvement in capacity has been assumed to arise from latent capacity already existing within firms and/or the reallocation of some staff (likely to be fairly junior) from other areas of the firm to work on criminal legal aid work	Discussions with MoJ See also page 35
Organic growth capacity	■ Organic growth of 20% has been assumed to be achievable through increased recruitment activity	Discussions with MoJ
Competition	■ For competition to exist it is assumed that there must be at least two bidders per contract. Two have been assumed to be new entrants to the market and only 75% of incumbent bidders are assumed to be of scale	Discussions with MoJ See also page 30

Firm viability – description and worked example

The viability method assesses whether firms can make a positive return based on a derived P&L

- We received analysis from Otterburn Legal Consulting providing current aggregated financial and information for crime firms / departments based on a firm size category in terms of the number of crime solicitors (1-5, 6-12, 13 +) and split by procurement area type (rural, urban, London)
- We used this data to create an average P&L area type (rural, urban and London) and derived ratios to calculate staff costs, and fixed and variable overheads
- Within each area, we identified the incumbents of sufficient scale to deliver a contract of the size analysed. Of these, the firm selected for viability assessment was the firm with the lowest revenues (including out of area, 50% of own client revenue and the proposed duty contract revenue)

Worked example

- In this illustrative market the proposed average fee reduction is 10.7%. The duty contract proposed is £0.38m, or £0.43m under current pricing arrangements. The out of area own client fees and the 50% of in area own client fees which firms are assumed to retain total £0.3m. We calculated the staff and overhead costs based on the smallest firm which was of sufficient capacity to handle this size of duty contract. We then applied the fee reduction to all revenues to determine the net profit. We then assessed the level of staff cost efficiency needed to achieve profitability

Before new contract

Illustrative firm	£m	% revenue
Out of area own client fees	0.20	*34.8*
50% of in-area own client fees (retained)	0.10	*17.4*
Duty fees	0.28	*47.8*
Total crime fees	**0.58**	***100.0***
Staff costs	(0.40)	*69.1*
Variable overheads	(0.11)	*19.0*
Fixed overheads	(0.04)	*7.2*
Net profit	**0.03**	***4.6***

Apply proposed duty contract value and calculate costs

After new contract (12m to Sept. 2013 fee levels)

Illustrative firm	£m	% revenue
Out of area own client fees	0.20	*27.7*
50% of in-area own client fees (retained)	0.10	*13.8*
Duty fees	0.43	*58.5*
Total crime fees	**0.73**	***100.0***
Staff costs	(0.40)	*55.3*
Variable overheads	(0.14)	*19.0*
Fixed overheads	(0.04)	*5.8*
Net profit	**0.14**	***19.9***

Apply proposed blended average fee reduction of 10.7% for this area

After new contract (revised fee levels)

Illustrative firm	£m	% revenue
Out of area own client fees	0.18	*27.7*
50% of in-area own client fees (retained)	0.09	*13.8*
Duty fees	0.38	*58.5*
Total crime fees	**0.65**	***100.0***
Staff costs	(0.40)	*61.9*
Variable overheads	(0.14)	*21.3*
Fixed overheads	(0.04)	*6.5*
Net profit	**0.07**	***10.4***

Derived from ratios for the average firm in each region

Initial assumption of 20% productivity improvement (see p35)

No variable overhead efficiency assumed (see p36)

Profitability requires staff cost efficiency improvement of 7% - £0.40+£0.07 profit = £0.47m max staff costs. £0.47m/£0.73m = 64.4% of revenue, a 7% improvement on 69.1% before new contract

Method

Firm viability – key profitability principles and assumptions

The firm viability method relies on a number of principles which are summarised below:

Principle	Definition	Source
Value reduction	■ Assumptions are based on MoJ value reduction estimates for each procurement area for an alternative option on fee proposals currently under consideration by MoJ. This includes: ■ Different fixed fees applied to i) London and non-London police station work and ii) two categories of magistrates' court representation ■ Inclusion of case outcome as an additional variable impacting fee levels in Crown Court litigation ■ Where out of area own client revenues are included (see below) the average in area fee reduction has been applied	Analysis provided by MoJ
Staff costs	■ Staff costs are assumed to be pro rated with activity and differ by procurement area type ■ They are equal to 72.1%, 72.7% and 69.1% of revenue for London, urban and rural areas respectively	■ Averages from Otterburn data (p21-25)
Staff cost efficiency	■ An initial assumption is applied of 20% average change in staff cost efficiency – this means that, for example, staff costs of 70% of revenue would reduced by 20% to 56% of revenue	■ Supporting analysis on page 35
Overheads	■ Overheads are assumed to increase in line with revenue at a rate of 18%, 16% and 19% for London, urban and rural areas respectively ■ In addition, no matter how small the firm there is an element of fixed overheads required. Based on analysis, these have been set to £40,607, £48,741and £41,953 for London, urban and rural areas respectively ■ ***Note that the two values for each procurement area type do not equate to standard notions of fixed and variable costs. The required overhead amount does not represent the fixed cost of any firm in these areas***	■ Supporting analysis of Otterburn data on pages 21, 23 and 25
Retention of own client revenues	■ We have assumed for our analysis that a firm can maintain its own client revenue arising outside of the procurement area being analysed, whether or not it wins duty contracts in other procurement areas ■ 50% of own client revenue generated in the area being analysed is also assumed to be retained by a firm. The capacity to deliver the remaining 50% of own client in area revenue has been included within the capacity method (see page 32). Associated revenue has therefore not been included in the viability method	
If the smallest firm of sufficient scale is viable then all larger firms are viable	■ For the firm being assessed, we applied the cost ratios before the fee reduction . We then applied the fee reduction to revenues and calculated the profit. If the firm showed a positive profitability under the proposed number of contracts it was considered viable ■ We selected the firm to assess by identifying the smallest firm which had sufficient capacity to deliver the proposed duty contract. If this firm was considered viable then all larger firms and all firms consolidating to become larger than this were assumed to be at least as profitable.	

Method

There appears to be potential to improve efficiencies within staff costs

In order to respond to the proposed fee cuts, based on the illustrative P&Ls derived from Otterburn data, firms across all procurement area types will likely be required to implement some efficiency measures

- It has been assumed that if a procurement area requires firms to achieve greater than a 20% efficiency on staff costs, then further investigation of the area is required. The 20% threshold was based on the first two quantifiable factors below. The other two factors are considered indicative of further cost saving potential, but have not been quantified

Factor	Description
1. Some firms are already more efficient than the average	■ Based on the analysis performed of staff costs as a percentage of income (on pages 21, 23 and 25), it can be seen that the lower quartile performers achieve a ratio that is 67% to 94% of the average ■ This indicates that at least a quarter of firms in the market are already more efficient than our model assumes and shows potential for others to achieve efficiency savings of 6% to 33%, particularly if additional revenue were awarded
2. Latent capacity	■ There are indications that there is latent capacity in the system as workload has declined without being matched by similar levels of staff reductions in firms – In 2012/13 the number acts of assistance in crime fell by 2% compared to the previous year and has fallen by 10% since 2007/08 (see page 14). This is supported by the Otterburn report which states: "*A significant fall in the volume of work was the main current issue raised by virtually all the firms, and this was attributable to falls in crime levels but also local decisions not to prosecute*"[(1)] – Otterburn's survey results also suggest that to date there is difficulty in reducing cost quickly ("*It would probably mean talking to staff about cutting wages – they have done what they can to cut other overheads*") and acknowledge that the impact of uncertainty makes it difficult for firms to plan[(1)] – These points suggest that firms have not yet right-sized to reflect volume changes. The Otterburn report states, "*Some firms were unwilling to expand because they would incur expense to do so; but others could expand significantly without increased overheads"* [(1)]
3. Leverage model changes	■ An approach to achieving these efficiencies may require a change in the leverage model employed by firms. As firms grow in size, utilisation of more junior resource will help increase costs at a lower rate ■ There is potentially a pool of untapped capability that could reduce salary costs (for example, 38% of College of Law graduates in 2010 were unable to get training contracts, albeit the majority of these managed to gain law related work e.g. as a paralegal)[(2)]
4. Pay restraint	■ We understand that to date, duty solicitors have been able to attract salary premiums due to the limited supply and allocation of slots to individuals. As a result of the proposed changes, in which firms are awarded the slots, there is potential for this premium to reduce over time

Source: (1) 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting
(2) '84% of College of Law's 2010 LPC Graduates Have Secured Work in Legal Profession, Survey Reveals', University of Law website, 25 May 2011

However, the potential for significant efficiencies within overheads appears limited

The relatively more fixed nature of overheads is such that no improvement is assumed in assessing viability

Factor	Description
Overheads	■ The main overhead appears to be property costs associated with offices. As many firms are locked into lease contracts, it is considered difficult to achieve savings in short term unless a break point is approaching – Otterburn data suggests that the number of years to the next break clause is 2 years for the lower quartile and 5 years for the upper quartile. The median was 2 years[(1)] – We note that some of the data points may include allocations for property costs based on valuable offices that firms maintain to attract a different client demographic for their other revenue streams. These allocations may be larger than if the firm solely practised criminal legal aid. However, the likelihood is that these firms would still incur these costs going forward.

Source: (1) 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting

Contents

Case study introduction

A dashboard was created for each procurement area with the key features described

The elements of an example dashboard are described below. Full detail for this case study is included on the next page

This chart plots each contract number against the change in average staff efficiency (X axis) and capacity requirement (as represented by market consolidation %) (Y axis). This can be used to inspect the solution ranges to identify solutions which improve either consolidation or viability. The red circle is used to highlight such solutions, "the range on inspection"

Range of number of contracts for which viability thresholds are met (change in average staff efficiency less than 20%)

Overall results

Range of number of contracts for which capacity thresholds are met (inorganic market consolidation less than 25% and minimum 3 incumbents of scale)

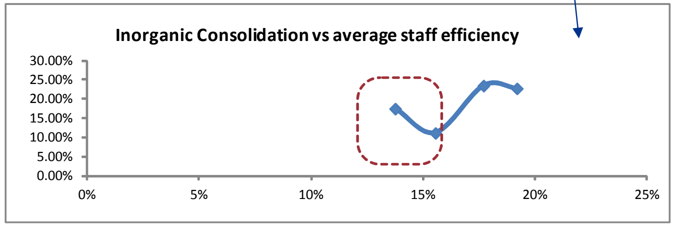
The range for which both conditions are satisfied

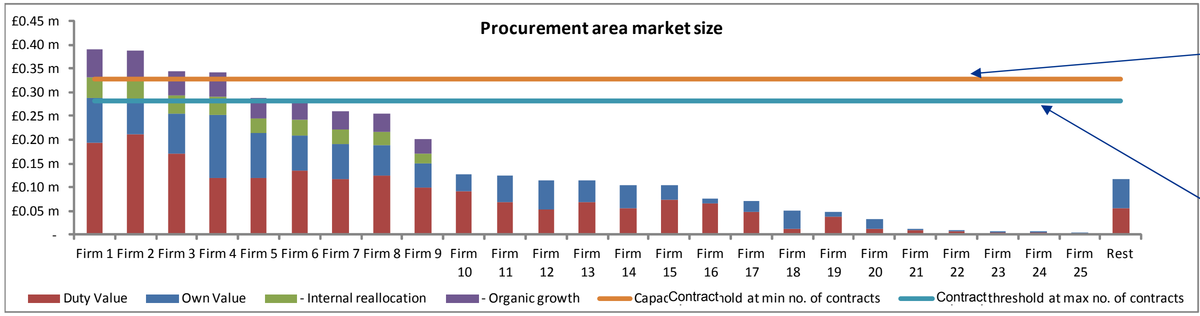
Adjustments to "inner range" of qualifying solutions after inspection of the relationship between market capacity and firm viability

Size of market (12 months to Sept 2013)	£2.86m
Procurement area type	Rural

Contracts:	6	7
Staff efficiency	14%	16%
Consolidation	18%	11%
Incumbents of scale	4	6

No. of contracts range	Min	Max
Viability range	6	9
Competition range	6	9
Inner range (viability - capacity)	6	9
Range after inspection	6	7
Duty contract value	£0.29m	£0.25m
Contract size threshold	£0.33m	£0.28m





Minimum number of contracts within range after inspection (larger contracts)

Maximum number of contracts within range after inspection (smaller contracts)

Case study 1
Area in which both viability and capacity challenges are within thresholds

Size of market (12 months to Sept 2013)	£2.86m
Procurement area type	Rural

Viability is satisfied for 5 to 8 contracts

No. of contracts range	Min	Max
Viability range	6	9
Competition range	6	9
Inner range (viability + competition)	6	9
Range after inspection	6	7

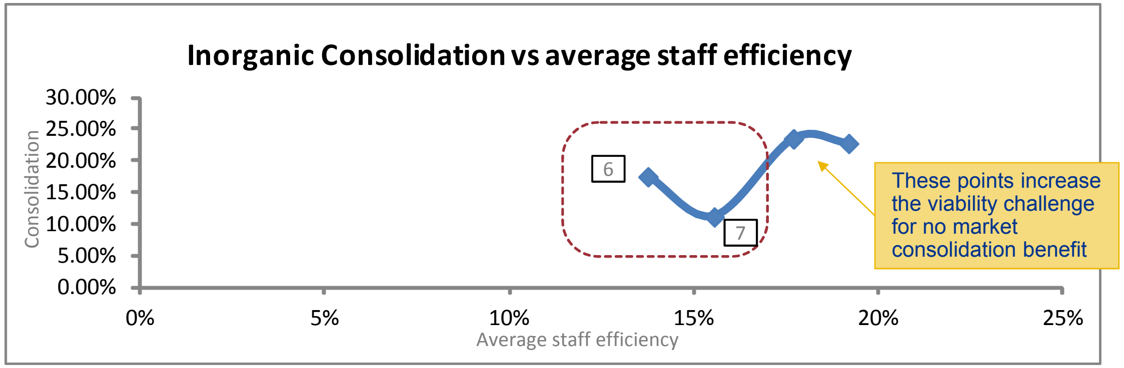
Capacity is satisfied for 6 to 9 contracts

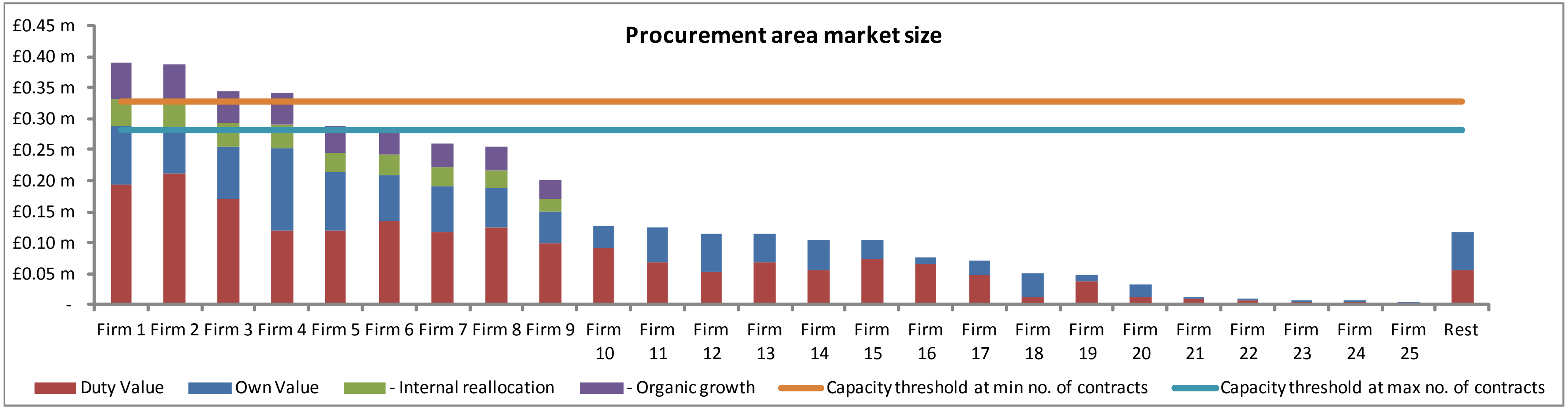
The range for which both conditions are satisfied is therefore 6 to 9 contracts

Duty contract value	£0.29m	£0.25m
Capacity threshold	£0.33m	£0.28m

Inspection of the relationship between the two requirements means that solutions with more than 7 contracts do not benefit capacity materially but do reduce viability

Contracts:	6	7
Staff efficiency	14%	16%
Consolidation	18%	11%
Incumbents of scale	4	6





Case study 2

Area in which the market consolidation required is less than 25% but where the average staff efficiency required is more than 20%

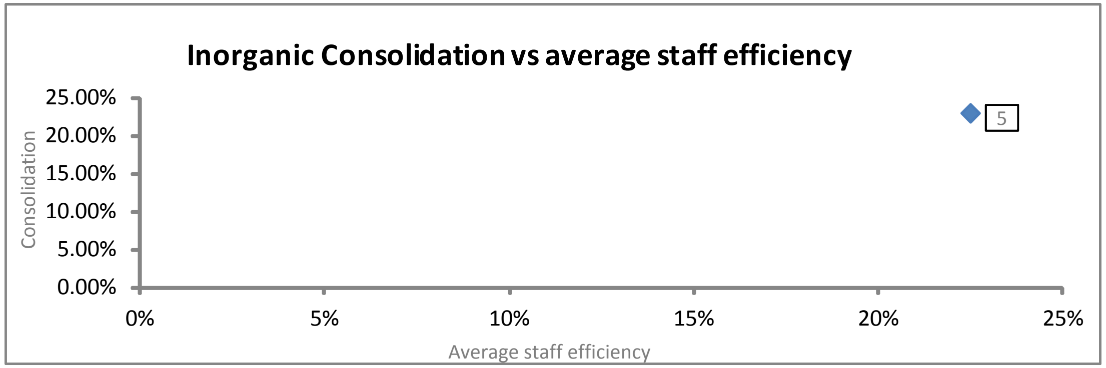
Size of market (12 months to Sept 2013)	£3.59m
Procurement area type	Urban

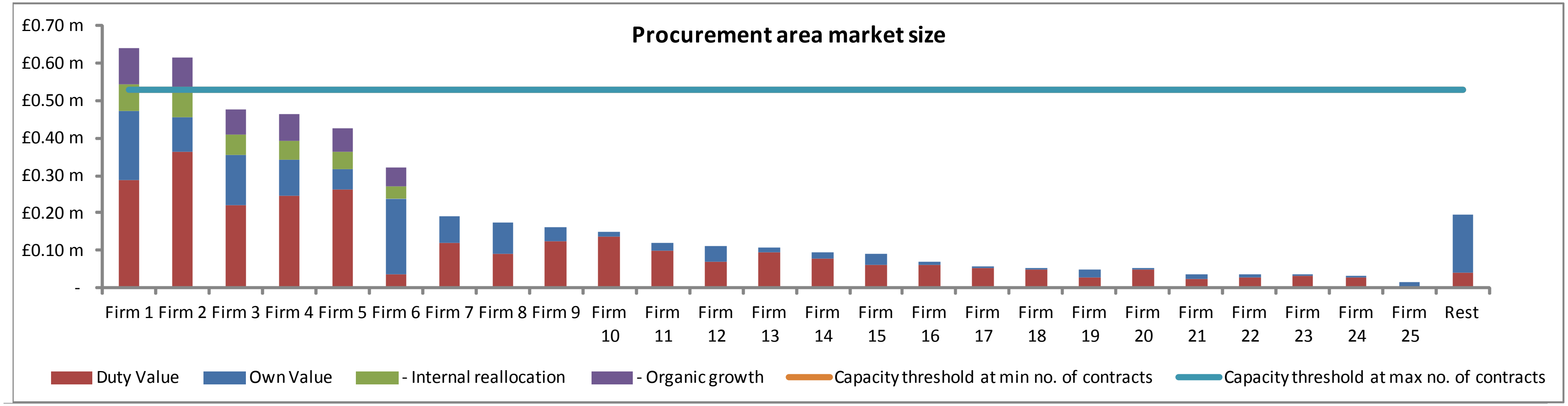
With 5 contracts, the change required in average staff efficiency is 22%

Contracts:	5	5
Staff efficiency	22%	22%
Consolidation	23%	23%
incumbents of scumbents of scale	2	2

No. of contracts range	Min	Max
Viability range	-	-
Competition range	5	5
Inner range (viability + competition)	-	-
Range after inspection	5	5
Duty contract value	£0.42m	£0.42m
Capacity threshold	£0.53m	£0.53m

If the number of contracts is 5 the market consolidation required is less than 25%





Case study 3

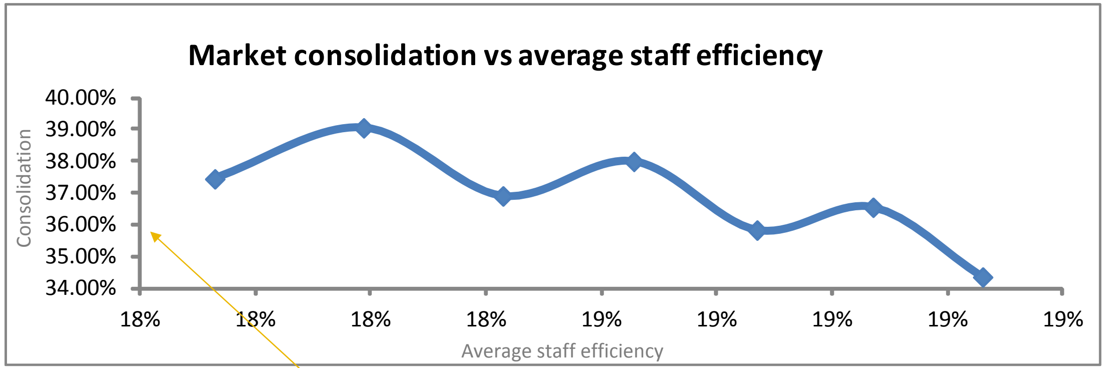
Area in which average staff efficiency is less than 20% but where the market consolidation required is greater than 25%

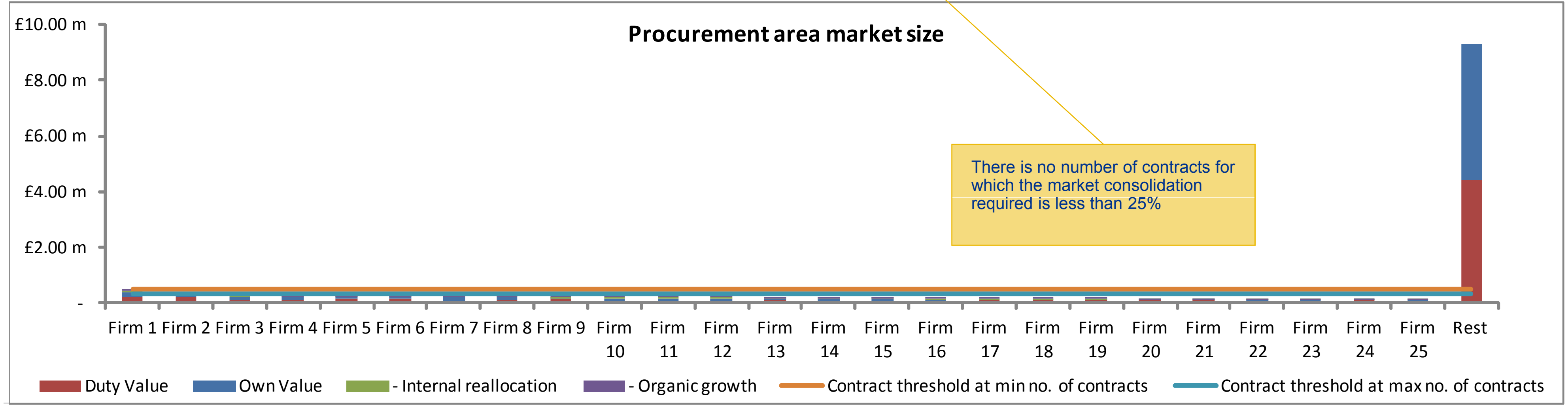
Size of market (12 months to Sept 2013)	£12.27m
Procurement area type	

If the number of contracts is 13, the change required in average staff efficiency is less than 20%

Staff Efficiency	18%	19%
Consolidation	37%	34%
Incumbents Of Scale	4	6

No. of contracts range	Min	Max
Viability range	13	19
Capacity range	-	-
Inner range (viability + capacity)	-	-
Range after inspection	13	19
Duty contract value	£0.42m	£0.29m
Contract size threshold	£0.52m	£0.35m





There is no number of contracts for which the market consolidation required is less than 25%

Contents

Results

23 of the 62 areas produced a range of contracts for which the viability and capacity challenges were within the initial thresholds and sufficient incumbents were of scale

There are 23 areas for which a range of contracts exists in which:

- The change in average staff efficiency required is less than 20% (viability threshold)
- The market consolidation required is less than 25% (capacity threshold)
- 3 or more incumbents are currently of scale

#	Area	Area Type	Market value (year to Sept 2013) £m			Fee Red^n	Average duty contract size (£m)		Inner Range of Contracts		Range by Inspection		Change in average staff efficiency		Consolidation required		No. Incumbents of scale	
			Own	Duty	Total		min	max	min	max	min	max	min	max	min	max	min	max
2	Avon & Somerset 2	U	4.4	2.2	6.6	16.2%	0.36	0.36	5	5	5	5	19%	19%	9%	9%	3	3
3	Bedfordshire	R	3.6	2.4	6.0	17.4%	0.40	0.40	5	5	5	5	13%	13%	24%	24%	3	3
5	Cambridgeshire	R	2.4	2.0	4.4	12.0%	0.29	0.25	6	9	6	7	14%	16%	18%	11%	4	6
8	Cleveland	U	4.4	1.0	5.3	4.6%	0.23	0.23	4	7	4	4	5%	5%	0%	0%	5	5
12	Devon & Cornwall 1	R	3.6	2.6	6.2	14.3%	0.28	0.28	8	11	8	8	20%	20%	20%	20%	3	3
15	Durham	R	2.9	1.5	4.4	13.5%	0.21	0.18	6	8	6	7	14%	15%	22%	18%	3	4
20	Gloucestershire	R	1.5	1.1	2.5	12.2%	0.23	0.23	4	4	4	4	18%	18%	0%	0%	5	5
21	Greater Manchester	U	21.5	10.3	31.8	18.5%	0.50	0.50	17	17	17	17	18%	18%	24%	24%	6	6
22	Gwent	R	3.1	1.4	4.4	14.1%	0.24	0.24	5	7	5	5	17%	17%	17%	17%	3	3
27	Humberside	R	4.5	2.1	6.6	14.1%	0.36	0.36	5	7	5	5	14%	14%	10%	10%	3	3
29	Lancashire	U	11.0	3.7	14.7	10.6%	0.55	0.25	6	15	6	13	6%	16%	16%	1%	3	15
32	Merseyside	U	12.8	4.0	16.8	18.2%	0.54	0.41	6	8	6	8	16%	19%	4%	1%	5	8
34	Norfolk 1	R	1.9	1.7	3.6	14.3%	0.37	0.37	4	4	4	4	17%	17%	17%	17%	3	3
42	North Yorkshire 2	R	2.0	0.9	2.8	12.9%	0.19	0.19	4	4	4	4	17%	17%	2%	2%	3	3
43	Northamptonshire	R	3.1	2.1	5.2	17.7%	0.34	0.34	5	7	5	5	17%	17%	9%	9%	3	3
44	Northumbria 1	R	4.5	0.8	5.3	13.7%	0.17	0.14	4	5	4	5	16%	17%	0%	0%	3	3
45	Northumbria 2	R	5.7	1.7	7.4	12.9%	0.30	0.21	5	7	5	7	13%	17%	1%	0%	3	3
46	Nottinghamshire	R	7.2	3.2	10.4	20.2%	0.63	0.63	4	5	4	4	15%	15%	17%	17%	3	3
49	South Wales	R	8.9	3.0	11.8	18.0%	0.35	0.27	7	9	7	9	17%	19%	15%	8%	3	4
51	South Yorkshire	U	6.6	3.1	9.7	14.2%	0.38	0.38	7	10	7	7	15%	15%	8%	8%	6	6
52	Staffordshire	R	6.2	2.2	8.4	16.6%	0.47	0.31	4	6	4	6	14%	16%	6%	5%	4	5
63	West Midlands	U	20.0	9.3	29.3	19.6%	0.58	0.58	13	14	13	13	18%	18%	23%	23%	4	4
64	West Yorkshire	U	16.8	5.7	22.5	14.1%	0.54	0.29	9	17	9	17	12%	18%	16%	4%	3	17
Total			**159**	**68**	**226**	**16.1%**	**0.47**	**0.40**			**143**	**169**	**15.1%**	**17.0%**	**14.8%**	**11.8%**		

Results

30 areas required inspection to determine a range of contracts. For 21 of these, the principle challenge was identified

For 30 areas we looked at the extent which a different set of assumptions might apply

- On inspection, the principle challenge facing each area was identified. Further consideration is required to assess whether the challenge is reasonable in the context of each market before confirming the number of contracts to be let

There are 6 areas in which the number of incumbents of scale is fewer than 3

- These are Cheshire, Derbyshire, Dyfed-Powys 2, Leicestershire, Lincolnshire and West Mercia 1

There are 5 areas in which the improvement in staff efficiency required is greater than 20%

- Cumbria 1 requires an improvement in average staff efficiency of 24%. For Hertfordshire, North Wales 1, Sussex 2 and West Mercia 2 this is 22%

There are 10 areas in which the market consolidation required is more than 25%

- The consolidation required varies from 27% in Thames Valley to 47% in Surrey. However, this may not be as significant in absolute terms i.e. the number of firms which need to combine. We recommend that MoJ considers these markets further to assess the absolute degree of consolidation or firm growth required

#	Area	Area Type	Market value (year to Sept 2013) £m			Fee Red^n	Average duty contract size (£m)		1st pass challenge	Range by Inspection		Change in average staff efficiency		Consolidation required		No. Incumbents of scale	
			Own	Duty	Total		min	max		min	max	min	max	min	max	min	max
7	Cheshire	R	3.2	2.0	5.2	13.7%	0.28	0.24	Incumbents	6	7	16%	18%	22%	13%	0	0
11	Derbyshire	R	4.7	2.2	6.9	20.3%	0.44	0.35	Incumbents	4	5	15%	21%	15%	4%	1	4
17	Dyfed-Powys 2	R	1.1	0.6	1.7	14.0%	0.13	0.13	Incumbents	4	4	18%	18%	23%	23%	2	2
30	Leicestershire	R	5.4	2.5	7.8	20.6%	0.49	0.49	Incumbents	4	4	20%	20%	13%	13%	2	2
31	Lincolnshire	R	1.9	2.2	4.1	13.7%	0.38	0.38	Incumbents	5	5	13%	13%	21%	21%	2	2
61	West Mercia 1	R	2.5	1.7	4.2	16.7%	0.28	0.28	Incumbents	5	5	19%	19%	18%	18%	1	1
9	Cumbria 1	R	0.9	0.6	1.5	8.7%	0.15	0.15	Viability	4	4	24%	24%	7%	7%	3	3
25	Hertfordshire	U	5.6	3.1	8.6	23.6%	0.47	0.47	Viability	5	5	22%	22%	27%	27%	1	1
38	North Wales 1	R	2.4	1.0	3.4	15.0%	0.21	0.21	Viability	4	4	22%	22%	5%	5%	3	3
57	Sussex 2	U	2.7	2.6	5.3	20.1%	0.42	0.42	Viability	5	5	22%	22%	23%	23%	2	2
62	West Mercia 2	R	1.5	1.0	2.5	15.6%	0.21	0.21	Viability	4	4	22%	22%	21%	21%	3	3
1	Avon & Somerset 1	R	1.9	1.8	3.7	19.5%	0.35	0.28	Capacity	4	5	22%	24%	40%	24%	3	1
14	Dorset	R	1.6	2.2	3.9	10.4%	0.40	0.40	Capacity	5	5	9%	9%	33%	33%	2	2
23	Hampshire 1	U	7.3	4.8	12.1	20.9%	0.55	0.55	Capacity	7	7	20%	20%	33%	33%	1	1
19	Essex	R	5.3	4.7	10.0	18.6%	0.54	0.54	Capacity	7	7	17%	17%	35%	35%	2	2
28	Kent	U	6.1	5.3	11.4	21.4%	0.60	0.60	Capacity	7	7	21%	21%	40%	40%	1	1
54	Suffolk 2	R	1.2	1.2	2.3	14.2%	0.26	0.26	Capacity	4	4	19%	19%	39%	39%	2	2
55	Surrey	U	3.3	2.7	6.0	21.6%	0.53	0.53	Capacity	4	4	20%	20%	47%	47%	1	1
56	Sussex 1	U	2.9	2.9	5.9	17.3%	0.61	0.49	Capacity	4	5	15%	17%	47%	36%	1	1
58	Thames Valley	U	10.5	6.0	16.5	19.6%	0.54	0.54	Capacity	9	9	16%	16%	27%	27%	3	3
65	Wiltshire	R	1.8	1.7	3.5	16.3%	0.29	0.29	Capacity	5	5	19%	19%	28%	28%	3	3
Total (Incumbents, Viability, Capacity challenges)			**74**	**53**	**127**	**18.6%**	**0.50**	**0.48**		**106**	**110**	**18.4%**	**19.0%**	**28.7%**	**26.7%**		

This column shows principle challenge on further inspection: Incumbents, Viability, or Capacity.

For example, if a market has a modest shortfall in the capacity that is required of one firm only and there is a small amount of capacity in the tail then, even though only one combination is needed, the relative market consolidation will be a high percentage

Results

There are 9 areas for which further consideration is needed to identify the principal challenge and confirm the range identified

For nine areas, a number of thresholds were exceeded under any number of contracts

- On inspection, for these areas the average staff efficiency improvement required is higher than 20%, even at the minimum of 4 contracts. Therefore, 4 contracts is the option suggested for the minimum viability challenge
- Proceeding on this basis, requires a judgement as to the achievability of the other challenges based on detailed consideration of these specific markets. This should take into account factors beyond those assessed quantitatively including:

1. The viability challenge in context of small firms

- The demonstrated capacity of providers in these areas is small. For example, 7 of these areas have total duty markets of below £1m
- The method to assess viability has limitations in small markets. Using aggregated data for firms of 1-5 solicitors may overstate overheads when applied to very small or sole practitioner firms
- Therefore, we recommend that further consideration is given to the specific viability challenge in each market taking account of local cost pressures and the estimated overhead profile of small partnerships or sole practitioners

#	Area	Area Type	Market value (year to Sept 2013) £m			Fee Red^{n}	Average duty contract size (£m)		1st pass challenge	Range by Inspection		Change in average staff efficiency		Consolidation required		No. Incumbents of scale	
			Own	Duty	Total		min	max		min	max	min	max	min	max	min	max
10	Cumbria 2	R	0.5	0.7	1.2	13.5%	0.16	0.16	Analyse	4	4	31%	31%	62%	62%	2	2
13	Devon & Cornwall 2	R	1.1	1.1	2.2	16.7%	0.22	0.22	Analyse	4	4	24%	24%	27%	27%	1	1
16	Dyfed-Powys 1	R	1.2	0.4	1.6	11.9%	0.09	0.09	Analyse	4	4	27%	27%	3%	3%	3	3
24	Hampshire 2	R	0.4	0.3	0.7	18.2%	0.07	0.07	Analyse	4	4	70%	70%	127%	127%	3	3
35	Norfolk 2	R	0.7	0.8	1.6	13.3%	0.18	0.18	Analyse	4	4	24%	24%	46%	46%	3	3
39	North Wales 2	R	0.6	0.5	1.1	17.0%	0.11	0.11	Analyse	4	4	44%	44%	0%	0%	3	3
41	North Yorkshire 1	R	0.6	0.4	1.0	17.3%	0.08	0.08	Analyse	4	4	38%	38%	11%	11%	2	2
53	Suffolk 1	R	0.5	0.6	1.2	15.3%	0.14	0.14	Analyse	4	4	36%	36%	74%	74%	2	2
59	Warwickshire	R	0.8	1.2	2.0	16.6%	0.25	0.25	Analyse	4	4	24%	24%	51%	51%	1	1
	Total (Analyse challenge)		**6**	**6**	**13**	**15.5%**	**0.17**	**0.17**		**36**	**36**	**31.7%**	**31.7%**	**40.1%**	**40.1%**		
	Total (Incumbents, Viability, Capacity challenges)		**74**	**53**	**127**	**18.6%**	**0.50**	**0.48**		**106**	**110**	**18.4%**	**19.0%**	**28.7%**	**26.7%**		
	Total with further inspection		**80**	**59**	**139**	**18.3%**	**0.42**	**0.40**		**142**	**146**	**19.6%**	**20.1%**	**29.7%**	**27.9%**		

2. The absolute amount of market consolidation needed in areas in which the challenge is higher than 25%

- As explained on the previous page, the absolute amount of market consolidation may not be as significant a challenge as the percentage suggests.
- For example, in Hampshire 2, in order to believe that sufficient capacity will be available requires a judgement that either incumbent firms could engage in more organic growth, that more out of area firms will bid or that firms would be prepared to retain less of their own client work to meet the capacity requirements of a duty contract

3. The size of incumbent as well as the number of scale

- The method counts the number of incumbents of scale after making assumptions about the amount of growth firms may be able to undertake. In Warwickshire, there is one incumbent of scale. On inspection, two further incumbents are identified who are not of scale but, with the assumed amount of organic growth, have a capacity which is less than £10,000 below the contract size. This means that for four contracts, instead of believing that three firms can achieve scale without consolidation with one needing to acquire capacity, one would need to believe that either three firms will be able to acquire capacity or that one firm can acquire capacity and two firms can grow more than is assumed elsewhere

Results

All nine London areas require further consideration. Large, fragmented markets mean that the consolidation required is greater than 25%

On the first pass, no London areas have a range of contract numbers for which the viability and capacity challenge is within the thresholds.

- The fragmented nature of the nine London procurement areas means that for the range of contracts in which the viability challenge is within thresholds the market consolidation challenge is higher than 25%
- The market consolidation required is still significantly above the 25% threshold, ranging from 38% consolidation required in South East London to over 75% in Central London. On average, the market consolidation required is 54%
- In addition, the number of incumbents of scale is fewer than three in six out of the nine areas

Therefore, a second pass analysis was undertaken for London areas in which smaller markets were considered

- The next section sets out the modified approach and the results of analysing markets at the police station duty scheme level. Each procurement area is made up of 3 or 4 police station duty schemes (32 in total across London)

#	Area	Area Type	Market value (year to Sept 2013) £m			Fee Red[n]	Average duty contract size (£m)		Inner Range of Contracts		Range by Inspection		Change in average staff efficiency		Consolidation required		No. Incumbents of scale	
			Own	Duty	Total		min	max	min	max	min	max	min	max	min	max	min	max
6	Central London	L	10.7	11.4	22.1	20.3%	0.76	0.70	12	17	12	13	19%	19%	75%	71%	1	1
18	East London	L	6.5	5.5	12.0	18.4%	0.50	0.41	9	14	9	11	17%	19%	53%	51%	1	2
36	North East London	L	7.6	6.1	13.7	18.9%	0.71	0.71	7	13	7	7	16%	16%	47%	47%	1	1
37	North London	L	10.4	7.5	17.9	19.5%	0.86	0.50	7	16	7	12	17%	19%	52%	53%	1	2
40	North West London	L	6.3	4.8	11.1	18.5%	0.56	0.56	7	14	7	7	16%	16%	54%	54%	1	1
47	South East London	L	7.3	4.9	12.2	18.0%	0.80	0.37	5	12	5	11	14%	20%	38%	43%	1	6
48	South London	L	8.5	6.5	15.0	19.4%	0.58	0.47	9	14	9	11	18%	20%	50%	45%	1	3
50	South West London	L	4.1	3.9	7.9	19.6%	0.39	0.35	8	10	8	9	20%	21%	63%	58%	1	1
60	West London	L	6.9	5.5	12.4	19.5%	0.74	0.49	6	11	6	9	18%	20%	52%	49%	1	3
Total London			**68**	**56**	**124**	**19.3%**	**0.80**	**0.62**			**70**	**90**	**17.2%**	**18.9%**	**55.0%**	**53.5%**		

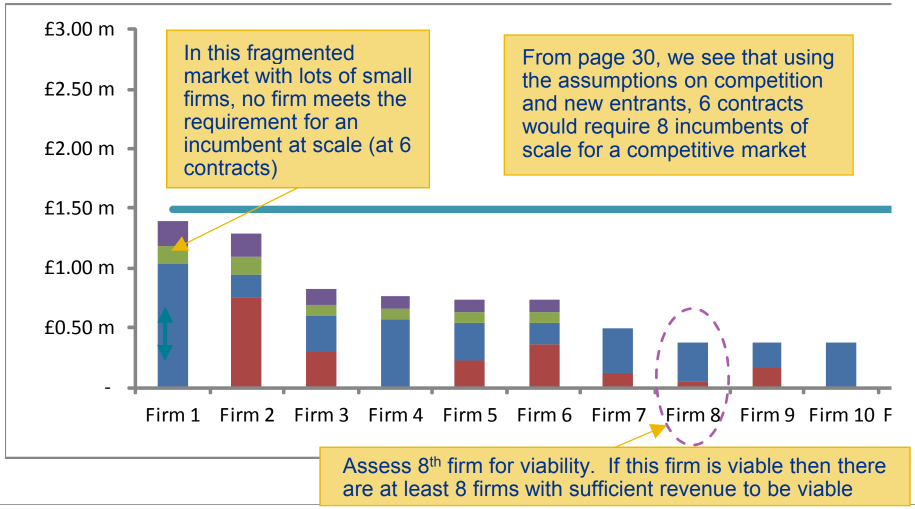
Contents

The London market is highly fragmented, creating a challenge in achieving the threshold for sufficient incumbents of scale.

In London, no options produced viability or capacity outcomes within the thresholds assumed and the scenarios used in the model. However, there are a number of alternative scenarios that could be assessed. We considered one scenario to understand the sensitivity of variations in our assumptions

- London was split into the smaller police station duty schemes of which there are between 3 and 4 within each original procurement area
- To reflect the interconnected market in London in which firms operate in multiple areas, alternative assumptions about new entrants and incumbents of scale were explored
- Applying these assumptions to the previous 9 areas produced only one area with an option for which the market consolidation was less than 25% This confirmed the need to explore smaller areas in London
- The viability assessment described on page 33 assesses the smallest incumbent of scale. However, in many potential scenarios in London, there is no one incumbent of scale. This means that to explore these alternative scenarios, the viability test must be modified, as shown below:

Illustrative London area – test for 6 contracts



Alternative scenario assumptions

	Main Method	London Method
Areas	**Number of original areas tested** ■ 9 proposed procurement areas	**Number of areas tested** ■ 32 new procurement areas based on police station duty schemes
Incumbents and new entrants	**Incumbents** ■ Three incumbents of scale required	**Incumbents** ■ No minimum incumbents of scale required
	New entrants ■ 2 new entrants assumed in each area	**New entrants** ■ 2 new entrants assumed in each area to determine inspected range ■ Then the capacity challenge is expressed for the inspected range of contracts if 4 new entrants are assumed
Viability	■ Select the smallest firm whose demonstrated capacity in the area exceeds the contract size threshold and assess this firm for viability	■ Select the firm with the nth largest capacity, where n is the required number of bidders of scale (see p30) ■ E.g. In a 6 contract scenario, the 8th largest firm is assessed for viability

When analysed in 32 police station duty scheme areas, the capacity challenge remains similar in percentage terms

The nine London regions have been disaggregated into 32 areas

- The use of smaller procurement areas leads to smaller average contract sizes in London when compared to the average for areas outside London
- 30 of these new smaller procurement areas produce a range of contract numbers for which the viability challenge is within the threshold i.e. the average staff efficiency improvement needed is less than 20%
- Richmond and Kingston have a higher viability challenge. These are very small markets with small proposed contract sizes and, as discussed on page 45, the method to assess viability has limitations for very small markets and contracts
- It may be that firms bidding for contracts in smaller areas may only be able to achieve a viable level of revenue by winning duty contracts in multiple police station duty schemes.
- This may have implications for the procurement process and MoJ should consider how to assess bids from firms in multiple procurement areas

The average market consolidation required is around 50% compared with 54% for London on a 9 area basis.

- As with 9 London areas, there is significant variability in the proportion of market consolidation required in each area, from 19% in Havering to 81% in Kingston-upon-Thames

#	Area	Area Type	Market value (year to Sept 2013) £m			Fee Red^{n}	Average duty contract size (£m)		Inner Range of Contracts		Range by Inspection		Change in average staff efficiency		Consolidation required		No. Incumbents of scale	
			Own	Duty	Total		min	max	min	max	min	max	min	max	min	max	min	max
1	Barking	L	1.8	1.7	3.5	18.9%	0.28	0.28	4	7	5	5	19%	19%	37%	37%	1	1
2	Bexley	L	1.1	0.6	1.8	18.0%	0.13	0.10	4	7	4	5	16%	17%	35%	33%	2	2
3	Bishopsgate	L	1.3	1.0	2.3	20.3%	0.20	0.16	4	8	4	5	19%	19%	62%	57%	0	0
4	Brent	L	3.2	2.8	5.9	18.5%	0.56	0.20	4	11	4	11	15%	21%	63%	63%	0	2
5	Brentford	L	1.7	1.5	3.2	19.5%	0.24	0.24	4	5	5	5	19%	19%	44%	44%	0	0
6	Bromley	L	1.9	1.2	3.1	18.0%	0.14	0.12	4	9	7	8	18%	20%	32%	30%	1	2
7	Camberwell Green	L	0.8	0.7	1.5	19.4%	0.14	0.11	4	5	4	5	19%	20%	66%	60%	0	0
8	Central London	L	7.8	8.2	16.0	20.3%	1.64	0.44	4	15	4	15	16%	21%	75%	70%	0	3
9	Clerkenwell/Hampstead	L	2.4	2.1	4.5	19.5%	0.43	0.19	4	11	4	9	17%	20%	66%	59%	0	1
10	Croydon	L	2.9	1.9	4.8	19.4%	0.31	0.22	4	7	5	7	18%	21%	41%	38%	1	2
11	Ealing	L	2.6	2.3	4.9	19.5%	0.37	0.37	4	7	5	5	17%	17%	56%	56%	0	0
12	Enfield	L	2.3	1.1	3.3	19.5%	0.22	0.22	4	7	4	4	17%	17%	25%	25%	2	2
13	Greenwich/Woolwich	L	4.2	3.1	7.3	18.0%	0.50	0.36	4	10	5	7	15%	16%	39%	40%	1	1
14	Haringey	L	2.5	1.9	4.4	19.5%	0.22	0.17	4	10	7	9	19%	20%	50%	46%	1	1
15	Harrow	L	1.5	0.9	2.3	18.5%	0.14	0.14	4	8	5	5	16%	16%	40%	40%	1	1
16	Havering	L	1.5	0.8	2.4	18.9%	0.17	0.17	4	7	4	4	17%	17%	19%	19%	3	3
17	Heathrow	L	0.2	0.3	0.5	19.5%	0.05	0.05	4	5	4	4	20%	20%	73%	73%	1	1
18	Hendon/Barnet	L	1.7	1.2	2.9	18.5%	0.19	0.19	4	9	5	5	17%	17%	42%	42%	1	1
19	Highbury Corner	L	3.3	2.4	5.7	19.5%	0.21	0.21	4	11	9	9	20%	20%	44%	44%	2	2
20	Kingston-upon-Thames	L	0.1	0.2	0.3	19.6%	0.03	0.03	-	-	4	4	25%	25%	81%	81%	1	1
21	Newham	L	1.7	1.6	3.3	18.4%	0.26	0.15	4	9	5	9	17%	22%	57%	49%	0	2
22	Old Street	L	2.5	2.0	4.6	18.9%	0.42	0.18	4	10	4	9	16%	19%	65%	50%	0	0
23	Redbridge	L	1.7	1.5	3.2	18.9%	0.30	0.24	4	6	4	5	18%	19%	56%	47%	0	0
24	Richmond-upon-Thames	L	0.6	0.6	1.3	19.6%	0.13	0.13	-	-	4	4	23%	23%	59%	59%	0	0
25	South London	L	2.4	2.4	4.8	19.6%	0.48	0.39	4	7	4	5	17%	18%	70%	62%	0	0
26	Sutton	L	1.8	1.1	2.8	19.4%	0.21	0.17	4	6	4	5	17%	18%	31%	22%	1	2
27	Thames	L	2.5	1.9	4.4	20.3%	0.37	0.21	4	7	4	7	18%	21%	50%	37%	0	2
28	Tower Bridge	L	3.0	2.8	5.8	19.4%	0.56	0.25	4	10	4	9	16%	19%	65%	54%	0	0
29	Uxbridge	L	2.3	1.5	3.8	19.5%	0.30	0.24	4	7	4	5	17%	17%	35%	26%	1	2
30	Waltham Forest	L	2.3	2.0	4.3	18.4%	0.41	0.18	4	10	4	9	15%	20%	60%	48%	0	3
31	West London	L	1.5	2.1	3.7	18.4%	0.44	0.35	4	8	4	5	15%	17%	76%	70%	0	1
32	Wimbledon	L	0.9	0.6	1.6	19.6%	0.13	0.07	4	7	4	7	18%	21%	51%	36%	0	1
	Total London		**68**	**56**	**124**	**19.3%**	**0.38**	**0.27**			**147**	**210**	**17.0%**	**19.2%**	**53.8%**	**48.9%**		

Further London analysis

The capacity challenge in London's 32 police station duty schemes is sensitive to the assumed number of new entrants

The smaller size of the London police station duty schemes means that firms may need to increase the number of areas in which they operate to achieve scale

- This means that the assumption of 2 new entrants per area (as described on page 30) may need to be revisited. The relative proximity of neighbouring areas compared with the distances involved outside London may mean that more new entrants could be expected.
- To assess the impact of a different assumption, the capacity challenge for each area was reassessed on the basis of 4 new entrants per area
- This also affected the viability assessment as more new entrants means fewer incumbent bidders of scale are required. Therefore the "nth largest firm" (as described on page 48) is different
- The average staff efficiency required is reduced from an average of 17-19% to 15-17%. The capacity challenge is reduced significantly from an average of 49-54% market consolidation to 28-36% consolidation
- On average the market consolidation required moves from 50% to 30%. Significant variation between areas remains with West London requiring no consolidation and Central London requiring 64%

Letting the number of contracts in the ranges shown would require the following to be true:

- If each market attracts 2 new entrants then on average the incumbents in the market would need to consolidate around 50% of the capacity within smaller firms
- However if each market attracts 4 new entrants then the incumbents would need to consolidate around 30% of the capacity within smaller firms (circled)

#	Area	Area Type	Market value (year to Sept 2013) £m			Fee Red[n]	Average duty contract size (£m)		Inner Range of Contracts		Range by Inspection		Change in average staff efficiency		Consolidation required		No. Incumbents of scale	
			Own	Duty	Total		min	max	min	max	min	max	min	max	min	max	min	max
1	Barking	L	1.8	1.7	3.5	18.9%	0.28	0.28	4	7	5	5	19%	19%	24%	24%	1	1
2	Bexley	L	1.1	0.6	1.8	18.0%	0.13	0.10	4	7	4	5	15%	16%	7%	20%	2	2
3	Bishopsgate	L	1.3	1.0	2.3	20.3%	0.20	0.16	4	8	4	5	18%	19%	33%	44%	0	0
4	Brent	L	3.2	2.8	5.9	18.5%	0.56	0.20	4	11	4	11	14%	20%	29%	54%	0	2
5	Brentford	L	1.7	1.5	3.2	19.5%	0.24	0.24	4	5	5	5	17%	17%	33%	33%	0	0
6	Bromley	L	1.9	1.2	3.1	18.0%	0.14	0.12	4	9	7	8	17%	18%	26%	20%	1	2
7	Camberwell Green	L	0.8	0.7	1.5	19.4%	0.14	0.11	4	5	4	5	17%	19%	33%	46%	0	0
8	Central London	L	7.8	8.2	16.0	20.3%	1.64	0.44	4	15	4	15	16%	21%	40%	64%	0	3
9	Clerkenwell/Hampstead	L	2.4	2.1	4.5	19.5%	0.43	0.19	4	11	4	9	16%	19%	33%	50%	0	1
10	Croydon	L	2.9	1.9	4.8	19.4%	0.31	0.22	4	7	5	7	18%	19%	29%	30%	1	2
11	Ealing	L	2.6	2.3	4.9	19.5%	0.37	0.37	4	7	5	5	17%	17%	41%	41%	0	0
12	Enfield	L	2.3	1.1	3.3	19.5%	0.22	0.22	4	7	4	4	17%	17%	1%	1%	2	2
13	Greenwich/Woolwich	L	4.2	3.1	7.3	18.0%	0.50	0.36	4	10	5	7	14%	16%	28%	31%	1	1
14	Haringey	L	2.5	1.9	4.4	19.5%	0.22	0.17	4	10	7	9	19%	20%	41%	38%	1	1
15	Harrow	L	1.5	0.9	2.3	18.5%	0.14	0.14	4	8	5	5	15%	15%	29%	29%	1	1
16	Havering	L	1.5	0.8	2.4	18.9%	0.17	0.17	4	7	4	4	17%	17%	0%	0%	3	3
17	Heathrow	L	0.2	0.3	0.5	19.5%	0.05	0.05	4	5	4	4	18%	18%	30%	30%	1	1
18	Hendon/Barnet	L	1.7	1.2	2.9	18.5%	0.19	0.19	4	9	5	5	16%	16%	31%	31%	1	1
19	Highbury Corner	L	3.3	2.4	5.7	19.5%	0.21	0.21	4	11	9	9	19%	19%	36%	36%	2	2
20	Kingston-upon-Thames	L	0.1	0.2	0.3	19.6%	0.03	0.03	-	-	4	4	18%	18%	25%	25%	1	1
21	Newham	L	1.7	1.6	3.3	18.4%	0.26	0.15	4	9	5	9	16%	20%	43%	40%	0	2
22	Old Street	L	2.5	2.0	4.6	18.9%	0.42	0.18	4	10	4	9	16%	18%	35%	43%	0	0
23	Redbridge	L	1.7	1.5	3.2	18.9%	0.30	0.24	4	6	4	5	16%	19%	26%	34%	0	0
24	Richmond-upon-Thames	L	0.6	0.6	1.3	19.6%	0.13	0.13	-	-	4	4	18%	18%	25%	25%	0	0
25	South London	L	2.4	2.4	4.8	19.6%	0.48	0.39	4	7	4	5	16%	18%	35%	48%	0	0
26	Sutton	L	1.8	1.1	2.8	19.4%	0.21	0.17	4	6	4	5	17%	17%	7%	15%	1	2
27	Thames	L	2.5	1.9	4.4	20.3%	0.37	0.21	4	7	4	7	0%	0%	0%	0%	0	2
28	Tower Bridge	L	3.0	2.8	5.8	19.4%	0.56	0.25	4	10	4	9	16%	19%	33%	44%	0	0
29	Uxbridge	L	2.3	1.5	3.8	19.5%	0.30	0.24	4	7	4	5	16%	17%	9%	16%	1	2
30	Waltham Forest	L	2.3	2.0	4.3	18.4%	0.41	0.18	4	10	4	9	15%	20%	32%	40%	0	3
31	West London	L	1.5	2.1	3.7	18.4%	0.44	0.35	4	8	4	5	0%	0%	0%	0%	0	1
32	Wimbledon	L	0.9	0.6	1.6	19.6%	0.13	0.07	4	7	4	7	17%	20%	25%	28%	0	1
	Total London		**68**	**56**	**124**	**19.3%**	**0.38**	**0.27**			**147**	**210**	**15.4%**	**17.4%**	**28.2%**	**35.7%**		

Further London analysis

The capacity challenge in the original 9 London procurement areas is also reduced with more new entrants

For 9 areas, the new entrants assumption also changes the consolidation challenge, although to a lesser extent

Letting the number of contracts in the ranges shown would require the following to be true:

- If each market attracts 2 new entrants then on average the incumbents in the market would need to consolidate around 55% of the capacity within smaller firms (see page 46)
- However if each market attracts 4 new entrants then the incumbents would need to consolidate around 45% of the capacity within smaller firms

#	Area	Area Type	Market value (year to Sept 2013) £m			Fee Red^{n}	Average duty contract size (£m)		Inner Range of Contracts		Range by Inspection		Change in average staff efficiency		Consolidation required		No. Incumbents of scale	
			Own	Duty	Total		min	max	min	max	min	max	min	max	min	max	min	max
6	Central London	L	10.7	11.4	22.1	20.3%	0.76	0.70	12	17	12	13	19%	19%	75%	71%	1	1
18	East London	L	6.5	5.5	12.0	18.4%	0.50	0.41	9	14	9	11	17%	18%	45%	44%	1	2
36	North East London	L	7.6	6.1	13.7	18.9%	0.71	0.71	7	13	7	7	16%	16%	35%	35%	1	1
37	North London	L	10.4	7.5	17.9	19.5%	0.86	0.50	7	16	7	12	17%	19%	43%	41%	1	2
40	North West London	L	6.3	4.8	11.1	18.5%	0.56	0.56	7	14	7	7	15%	15%	46%	46%	1	1
47	South East London	L	7.3	4.9	12.2	18.0%	0.80	0.37	5	12	5	11	14%	19%	28%	36%	1	6
48	South London	L	8.5	6.5	15.0	19.4%	0.58	0.47	9	14	9	11	18%	20%	42%	40%	1	3
50	South West London	L	4.1	3.9	7.9	19.6%	0.39	0.35	8	10	8	9	20%	21%	42%	48%	1	1
60	West London	L	6.9	5.5	12.4	19.5%	0.74	0.49	6	11	6	9	16%	20%	29%	41%	1	3
Total London			**68**	**56**	**124**	**19.3%**	**0.80**	**0.62**			**70**	**90**	**16.9%**	**18.6%**	**45.2%**	**46.2%**		

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Summary of results

If London is procured as 9 areas then the range of contracts across England and Wales is 355 to 405. If London is procured as 32 areas then the range is 432 to 525

Within the non-London areas, the analysis indicates a range of 285 to 315 contracts

- On average, these would require a change in average staff efficiency of around 18% and market consolidation of around 20%
- This assumes that the 9 areas for whom the viability challenge was most significant can be procured with 4 duty contracts each

In London for 9 areas, the analysis indicates a range of 70 to 90 contracts

- On average, these would require a change in average staff efficiency of around 18% and market consolidation of around 54% (45% with 4 new entrants)

In London for 32 areas, the analysis indicates a larger range of 147 to 210 contracts

- On average, these would require a change in average staff efficiency of around 18% and market consolidation of around 50% (30% with 4 new entrants)

Summary	Market value (year to Sept 2013) £m			Average duty contract size (£m)(1)		Range by Inspection		Change in average staff efficiency		Consolidation required		Change in average staff efficiency		Consolidation required	
	Own	Duty	Total	min	max	min	max	min	max	min	max	min	max	min	max
Non-London total without further inspection	159	68	226	0.47	0.40	143	169	15.1%	17.0%	14.8%	11.8%				
Non-London total with further inspection	80	59	139	0.42	0.40	142	146	19.6%	20.1%	29.7%	27.9%	*With 4 new entrants per London area:*			
Non-London total	**239**	**127**	**366**	**0.44**	**0.40**	**285**	**315**	**17.2%**	**18.4%**	**21.7%**	**19.3%**				
London 9 areas (2 entrants)	68	56	124	0.80	0.62	70	90	17.2%	18.9%	55.0%	53.5%	16.9%	18.6%	45.2%	46.2%
London 32 areas (2 entrants)	68	56	124	0.38	0.27	147	210	17.0%	19.2%	53.8%	48.9%	15.4%	17.4%	28.2%	35.7%
England and Wales Total (London on 9 area basis)	**307**	**183**	**490**	**0.51**	**0.45**	**355**	**405**	**17.2%**	**18.6%**	**31.9%**	**29.8%**	**17.1%**	**18.5%**	**28.9%**	**27.5%**
England and Wales Total (London on 32 area basis)	**307**	**183**	**490**	**0.42**	**0.35**	**432**	**525**	**17.2%**	**18.7%**	**31.6%**	**28.4%**	**16.7%**	**18.1%**	**23.7%**	**24.3%**

To determine the number of contracts to let within the range identified for each area, and to decide whether to procure London on a 9 area or 32 police station duty scheme basis requires a number of additional factors to be considered

- The use of smaller procurement areas leads to over twice as many contracts with a smaller average contract size in London when compared to areas outside London. This can offer flexibility for firms to consider strategies appropriate to their size including competing for multiple area contracts. 89 firms currently earn fees in more than 16 of the 32 smaller areas
- Procuring on the 32 area basis will increase the procurement effort to evaluate 32 competitions in place of 9. In addition, firms who choose to bid in multiple areas to gain sufficient scale to be viable or to grow their businesses will be faced with a greater number of tenders to produce. The approach to evaluating bids from such firms will also need to be considered

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Firms may choose alternative strategies to meet the growth required in capacity in order to deliver larger duty contracts

In order to deliver new duty provider contracts, firms will need to have the capacity to deliver increased volumes of duty provider work

- This capacity growth could be secured in a number of different ways:
  1. Redeploy capacity currently delivering own client work to prioritise duty provider work
  2. Improved productivity of existing staff i.e. through use of latent capacity already within firms
  3. Organic growth through recruitment of individuals
  4. Inorganic growth through mergers, acquisitions or other alliance structures
- The method explained on pages 29-31 illustrates the extent to which inorganic growth (4) is required given assumptions on the potential for improved productivity (2) and organic growth (3) and assuming that 50% of own client capacity is redeployed (1)
- However, it is recognised that the strategy for achieving capacity growth will differ on a firm by firm basis and will ultimately be a business decision that reflects each firm's circumstances
- In particular, we understand that firms may be reluctant to redeploy staff from own client work and may therefore prioritise other options

The analysis in this report does not take account of individual firms' strategies, not least because all data was provided to KPMG on an anonymised and/or aggregated basis

- A number of factors which affect market consolidation are set out on the next page
- In selecting the number of contracts to let within the proposed inspected range, consideration should be given to the impact of these factors in each area to reflect on the relative priority of the viability challenge compared with the capacity challenge

The achievability of market consolidation will be impacted by a number of factors

As discussed on pages 30 and 31, our market capacity analysis produces an assessment of consolidation required within each area to enable the proposed number of contracts to be let. This is expressed in terms of the total capacity shortfall among incumbent firms required to be of scale as a proportion of remaining market capacity

As shown in the Results section, the consolidation requirement varies depending on current levels of market concentration in each procurement area. The extent to which the required level of consolidation is achievable will be dependent upon a number of factors:

Development of structures that appropriately share risk and reward

- Consolidation could be achieved through acquisitions, mergers, the establishment of a joint venture or alternative business structure, or increased use of self-employed, independent contractors
- Firms will need to consider which of these options best suits their aims and future strategy
- Negotiation will be required between parties to ensure arrangements reflect the interests of all parties and that the risk of new ventures is fairly shared e.g. on a joint and several basis

Securing regulatory approval for new structures

- An alternative business structure or JV consortium may be the preferred consolidation method for some firms
- It is currently unclear as to how the Solicitors Regulation Authority will seek to regulate and approve these organisations
- Requirements for a Compliance Officer for Legal Processes and a Compliance Officer for Financial Affairs will need consideration. Individuals may not be willing to assume this role for such disaggregated entities

Ability to manage conflicts of interest between consolidating firms

- Firms will need to consider the extent of conflicts of interest that arise as a result of combining client bases into one firm
- This applies not just on legal aid or criminal work, but across the wider client and case portfolio
- An appropriate level of due diligence will be required to ascertain level of conflicts. Strategies, processes and systems will be needed to manage these in advance of consolidation

Ability to source funds for investment in consolidation

- Any structural change within an organisation will likely incur investment costs (professional fees, relocation and redundancy costs, opportunity cost of management time)
- The scale of this cost has not been estimated
- However, Otterburn analysis demonstrates that providers have limited reserves to fund these costs
- The next page gives further commentary on wider investment cost requirements

Cultural change and increased business mindset

- The market's preference for independence may act as a significant cultural barrier to consolidation
- So too could the *'lack of management capability amongst some players'*[1], which may inhibit firms from proactively developing forward-looking strategies for new market dynamics

Sufficient time to implement a consolidation process

- The complexity of the issues noted on this page indicate that the time horizon for firms to design and implement a successful consolidation strategy may be significant

Source: (1) Deloitte, 'The Government's proposed legal aid reforms: A report for the Law Society', May 2013

Other considerations

Firms are likely to require a level of investment funding to successfully transition to new duty provider contracts

Investment funding may be required in three areas

- To fund increased working capital that arise as a result of larger contracts
- To fund the investment required to achieve the staff efficiency levels implied by the proposed contracts
  - For example, IT spend on digital technologies and virtual working could increase productivity and enable greater geographic coverage
- To fund the costs of consolidation as outlined on the previous slide

We have not sought to quantify the likely size of this funding

In this context, it is important to note that Otterburn's survey data indicates that firms have limited cash available for investment

- The median cash balance across the full sample was £16,490, with a significant range between the upper and lower quartiles and also by size of firm
- Both the median 13-40 and 40+ solicitor firms were in an overdraft position of -£30,000 and -£371,860 respectively

In addition, the market believes that it will struggle to obtain funding from lenders

- *'The investment opportunities which may occur in 2015, such as our applying for contracts in neighbouring areas could not be taken up with our balance sheet taking any further hit... We will simply not be able to secure investment funding'*[1]
- This aligns with Deloitte's interview findings with financial service providers: *'We see the legal aid sector as being challenging in terms of cash flow and profitability, compared to several other areas of legal work'*[2]

Source: (1) 'Transforming Legal Aid: Next Steps, A Report for the Law Society of England and Wales and the Ministry of Justice', Otterburn Legal Consulting, November 2013
(2) Deloitte, 'The Government's proposed legal aid reforms: A report for the Law Society', May 2013

Other considerations

The competitiveness of the market over the longer term requires further assessment

As outlined on page 30, the assumptions applied to competition parameters are designed on the basis that in each procurement area there should be a higher number of bidders than those awarded contracts. This should ensure competitive tension for this first round of tendering

- The extent to which firms that are not awarded contracts will be able to survive in the market during the four to five year period until the next competition has not been considered in detail
  - Own client work may be sufficient to support these firms through the initial contract period, especially given that a number of providers are likely to exit the market
  - However, given the importance of duty provider work in establishing relationships between new clients and solicitors, anecdotal evidence suggests that own client work for those providers without duty contracts will be likely to decline over time. This is uncertain
- By the point at which MoJ announces its third generation procurement for criminal legal aid services (e.g. in eight years time – assuming two four year contracts), the market may no longer be competitive under the same procurement terms (for example, there may be a one for one relationship between number of bidders and the number of contracts available, resulting in no competitive tension)
  - A possible mitigation for this would be to change the parameters of the competition at that point in time e.g. by changing procurement areas, reducing the number of contracts available etc. These options are speculative and would need to be adjusted to reflect actual market conditions at point of competition

New market entrants, either through existing firms expanding into new areas or new organisations entering the market, could provide a mitigating solution. However, the market does not exhibit the characteristics of an attractive investment opportunity

- Market volumes are declining as a result of falling levels of crime and changing sentencing patterns
- Marginally profitable contracts (as modelled in our analysis) are unlikely to generate high enough returns to encourage investment in the market
- *'Since ABS liberalisation of ownership, we have seen no evidence of interest on the part of external capital in the legal aid sector'*[1]

There is also a risk that downward market trends could discourage trainee solicitors from specialising in criminal law

- Whilst in the short term, this may help alleviate any overcapacity in the market, in the longer term this has the potential to jeopardise the future strength of the profession

We have used firm profitability as the threshold for viable firms. However firms which are marginally profitable may not provide sufficient reward for equity partners to compensate them for their risk

- In the analysis of firm viability, the equity partners within firms are attributed a notional salary in order for like-for-like comparisons to be made between firms with different equity partner structures. If the notional salary is thought of as reward for equity partner's time, then the share of the net profits can be considered reward for the risk and investment they have made in running a practice.
- If firms are marginally profitable this element of reward may not be high enough to encourage new equity partners. This means that as existing equity partners retire, the overall number of equity partners may shrink. In the longer term this may pose a threat to sustainability.

Source: (1) Deloitte, 'The Government's proposed legal aid reforms: A report for the Law Society', May 2013

Other considerations

Certain aspects of the proposals are outside the scope of our work. These may have an impact on overall assessment and are noted below for completeness

Firms unsuccessful in securing duty provider contracts

- Under the proposed number of duty provider contracts there will be a significant number of existing firms who will not be successful in winning future work. Those firms will be faced with the choice of consolidating with successful bidders, downsizing or growing their own client work in order to remain financially viable
  - This strategic decision will need to be taken in the context of each firm's specific circumstances. For example, factors such as the scale of the cost of closure (i.e. property lease exit costs, redundancy payments etc.), partner age profile and personal circumstances may lead to differing outcomes for different firms
  - The impact of the proposed number of contracts on providers who are unsuccessful in the procurement process was not part of our scope and has not been considered further

Other components of solution viability

- Our approach to viability has focused on the profitability impact of different numbers of contracts in each procurement area
- However, assessment of overall viability may also consider other topics. We have relied upon analysis and assumptions previously made by MoJ in the following areas:
  - *Geographies and travelling time*: In determining the 62 proposed procurement areas, MoJ has conducted analysis on the travelling time between the two delivery points (police station, magistrates' court, Crown Court) that are furthest apart. A maximum limit of 1.5 hours travelling time by car between these points has been imposed. We have not sought to revisit this assumption in performing our analysis
  - *Case mix variability:* MoJ considers that it is reasonable to expect providers to absorb up to a 3% change in revenue relative to what they would have received on the same mix of cases as a result of the introduction of fixed fee schemes and the impact of case mix variability. We have not tested the contract numbers proposed against this assumption

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Appendix 1

Procurement area classification by procurement area type

The tables below show the classification of procurement areas into rural, urban and London. This is based upon the areas used within the Otterburn report for those areas in which firms were sample in order for survey data and MoJ data to be comparable. For other areas, the MoJ classification has been applied.

	Procurement area	Procurement area type
1	AVON & SOMERSET 1	Rural
2	AVON & SOMERSET 2	Urban
3	BEDFORDSHIRE	Rural
4	BTP	N/a
5	CAMBRIDGESHIRE	Rural
6	CENTRAL LONDON	London
7	CHESHIRE	Rural
8	CLEVELAND	Urban
9	CUMBRIA 1	Rural
10	CUMBRIA 2	Rural
11	DERBYSHIRE	Rural
12	DEVON & CORNWALL 1	Rural
13	DEVON & CORNWALL 2	Rural
14	DORSET	Rural
15	DURHAM	Rural
16	DYFED-POWYS 1	Rural
17	DYFED-POWYS 2	Rural
18	EAST LONDON	London
19	ESSEX	Rural
20	GLOUCESTERSHIRE	Rural
21	GREATER MANCHESTER	Urban
22	GWENT	Rural

	Procurement area	Procurement area type
23	HAMPSHIRE 1	Urban
24	HAMPSHIRE 2	Rural
25	HERTFORDSHIRE	Urban
26	HMRC	N/a
27	HUMBERSIDE	Rural
28	KENT	Urban
29	LANCASHIRE	Urban
30	LEICESTERSHIRE	Rural
31	LINCOLNSHIRE	Rural
32	MERSEYSIDE	Urban
33	MOD	N/a
34	NORFOLK 1	Rural
35	NORFOLK 2	Rural
36	NORTH EAST LONDON	London
37	NORTH LONDON	London
38	NORTH WALES 1	Rural
39	NORTH WALES 2	Rural
40	NORTH WEST LONDON	London
41	NORTH YORKSHIRE 1	Rural
42	NORTH YORKSHIRE 2	Rural
43	NORTHAMPTONSHIRE	Rural
44	NORTHUMBRIA 1	Rural

	Procurement area	Procurement area type
45	NORTHUMBRIA 2	Rural
46	NOTTINGHAMSHIRE	Rural
47	SOUTH EAST LONDON	London
48	SOUTH LONDON	London
49	SOUTH WALES	Rural
50	SOUTH WEST LONDON	London
51	SOUTH YORKSHIRE	Urban
52	STAFFORDSHIRE	Rural
53	SUFFOLK 1	Rural
54	SUFFOLK 2	Rural
55	SURREY	Urban
56	SUSSEX 1	Urban
57	SUSSEX 2	Urban
58	THAMES VALLEY	Urban
59	WARWICKSHIRE	Rural
60	WEST LONDON	London
61	WEST MERCIA 1	Rural
62	WEST MERCIA 2	Rural
63	WEST MIDLANDS	Urban
64	WEST YORKSHIRE	Urban
65	WILTSHIRE	Rural

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