

# MINISTRY OF JUSTICE

Assessment of the financial impact of  
the proposed fee reductions on criminal  
legal aid law firms

(DRAFT)

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**Corporate Headquarters:**  
PA Consulting Group  
123 Buckingham Palace Road  
London SW1W 9SR  
UK  
Tel: +44 20 7730 9000  
Fax: +44 20 7333 5050  
[www.paconsulting.com](http://www.paconsulting.com)

**Prepared by:**

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# EXECUTIVE SUMMARY

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The Ministry of Justice (MoJ) is seeking to make annual savings of £220 million by 2018/19 through a complex reform programme to both civil and criminal legal aid. £120 million of these savings are expected to be generated from a new competition for criminal legal aid which will introduce a cap on the fee level providers earn from criminal legal aid services. We have been asked to undertake a short assurance exercise to assess the impact of the proposed criminal legal aid fee reductions on the financial sustainability of the current provider base. The review has been based on our experience of other large scale sourcing programmes and the legal services market. Given sensitivities, we have not undertaken any engagement at this stage with the legal market and so have relied upon publically available information and experience.

The ability of firms to sustain fee reductions will depend on the following factors:

- the scope for firms to reduce their costs by implementing efficiency savings (either from economies of scale or economies of scope);
- the scope for firms to reduce their costs from salary reductions;
- the proportion of the firms revenue sources that are derived from criminal legal aid (i.e. how big a proportion of the firm's profits are derived from criminal legal aid); and
- the level of profitability of firms (i.e. the extent to which reduced fees can simply be absorbed by reduced profits).

There is very limited data on the above factors and therefore it has not been possible to form any substantive definitive conclusions. However, based on the available information **the indicative assessment** is that a 8.75% reduction in criminal legal aid, as part of the introduction of competition into the market, may be sustainable for the firms with median levels of profitability and above (assuming only 50% of a firm's revenue is derived from criminal legal aid). In this scenario, an 8.75% reduction in fee levels, is expected to reduce firms' median margins to 1.6%. A further 8.75% reduction is however only likely to be potentially sustainable for the top 25% firms in terms of profitability.

It is likely firms even with positive profit levels may decide the profit levels forecasted are not sufficient to sustain them in the market due to the impact on the levels of available working capital. Similarly, even if firms do not have liquidity constraints, firms may still take the view there is insufficient incentive/ returns to remain in the market. No assessment can be made in terms of the number of firms that may exit the market this way as this is an individual corporate decision.

Smaller firms, due to their lower rates of costs per hour, are better placed to sustain the reductions in revenue than larger firms. As criminal legal aid fees are not spread equally across the country, certain regions are likely to be more affected by the reductions in fees levels than others; London, Greater Manchester, West Midlands and West Yorkshire are likely to be most affected. Similarly as you would

expect, firms who have a greater reliance on criminal legal aid revenues will struggle more to maintain profit levels than those who have a more diverse set of revenue streams.

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# 1 INTRODUCTION

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## 1.1 Background

The proposed reforms to legal aid by the Ministry of Justice seek to make annual savings of £220 million by 2018/19. This is through a number of changes which amend the scope, fee level and approach to contracting through the introduction of price competitive tendering (PCT) for criminal legal aid. The fee reductions associated with the introduction of price competitive tendering will be the focus on this paper.

Over the last five years the criminal legal aid market has already faced declining fees and volumes of business that has put incumbent providers of criminal legal aid under increasing pressure. In terms of volumes – the British Crime Survey reported crime rate falling by nearly 4 per cent a year in England and Wales since 2007 and subsequent reductions in demand for criminal court proceedings from 1.8 million in 2007 to around 1.5 million in 2012. Legal aid fees are also reported as declining in real terms since 1994<sup>1</sup>.

## 1.2 Proposed Model

The Ministry of Justice have published plans to introduce a wide range of reforms to legal aid. An overview of these reforms is provided below. The reforms fall into five broad categories – reforms to eligibility and scope, the introduction of competition into the criminal legal aid market, reforming fees in criminal legal aid (outside of the competition mechanism), reforming fees in civil legal aid and reforming the approach to expert fees in civil, family and criminal proceedings.

The MoJ legal aid reforms involve:

*Reforms to eligibility and scope through:*

- reforms to prison law to ensure that legal aid is not available for matters that do not justify the use of public funds such as treatment issues;
- the introduction of a household disposable income threshold above which defendants would no longer receive criminal legal aid;
- the introduction of a residence test for civil legal aid claimants;
- reforms to reduce the use of legal aid to fund weak judicial reviews; and
- amendments to the civil merits test to prevent the funding of any cases with less than a 50% chance of success.

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<sup>1</sup> Deloitte (May 2013) *The Government's proposed legal aid reforms*

*Introducing competition in the criminal legal aid market through:*

- the introduction of price competition into the criminal legal aid market, initially for the full range of litigation services (except Very High Cost Cases (Crime) VHCCs) and magistrates' court representation.

*Reforming fees in criminal legal aid (outside of competition mechanism) through:*

- a proposal to restructure the current Advocacy Graduated Fees Scheme to encourage earlier resolution and more efficient working through a harmonisation of guilty plea, cracked trial and basic trial fee rates to the cracked trial rate, and a reduction in and tapering of daily trial attendance rates from day three;
- a proposal to reduce all VHCC rates by 30%; and
- a proposal to tighten the rules governing the decision to appoint multiple counsel in a case, changes to litigator contracts to require greater support to counsel from the litigation team, and the introduction of a more robust and consistent system of decision-making.

*Reforming fees in civil legal aid through:*

- reducing solicitor representation fees in family public law cases by 10%, to align the fees for barristers and other advocates in non-family cases; and
- removing the 35% uplift in provider legal aid fees in immigration and asylum appeals.

*Reforming approach to expert fees in civil, family and criminal proceedings:*

- the proposal to reduce fees paid to experts in civil, family and criminal cases by 20%.

This paper is confined to a consideration of the proposed introduction of competition into the criminal legal aid market work - specifically the decision regarding the minimum level of savings bids must achieve. The paper does however recognise that the wider MoJ reforms will impact the same firms being assessed in the paper's analysis and notes this when forming conclusions.

## 1.3 Purpose of this document

PA Consulting was asked to undertake a short assurance exercise assessing the impact of the proposed criminal legal aid fee reductions on the financial sustainability of the current provider base. Within this analysis we were specifically tasked with making an assessment of an 8.75% reduction in fees, if it were introduced in February 2014, and a further 8.75% reduction in fees, if it were introduced in May 2015.

Our review has been based on the available information, and our experience of other large scale sourcing programmes and the legal services market. Given sensitivities and time constraints, we have not undertaken any engagement at this stage with the legal market. In many areas, there is insufficient data to provide definitive assessments, and therefore we have relied upon our judgement and experience to inform the assumptions in the analysis.

The purpose of this document is to make an initial high level assessment of the financial impact of the proposed criminal legal aid fee reductions. We also provide recommendations for further activity which would enable a more definite assessment.

The document is structured as follows:

- Section 2: Current financial position of firms
- Section 3: Impact of reduction in fees

# 2 CURRENT FINANCIAL POSITION OF FIRMS ENGAGED IN CRIMINAL LEGAL AID WORK

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In this section we assess the structure of the criminal legal aid market and the current profitability and liquidity of firms involved, to provide an understanding of the financial position of firms prior to the reforms.

## 2.1 Structure of the market

Around a third of firms undertake legal aid work. Over half of firms who conduct legal aid work, reported that 50% or more of their clients were legally aided, and just over a quarter reported that 90% or more of their clients were legally aided<sup>2</sup>.

There was no correlation between providing legal aid services and whether the firm engages in a broad or narrow practice. However, firms with large legal aid practices do tend to be more focused on narrow practice of legal aid work and those who do specialise tend to focus on criminal legal aid. An NAO survey found that a higher proportion of sole practitioners derived 100% of their revenue from criminal legal aid work alone compared to larger firms which had more diverse work portfolios.

The criminal legal aid market is fragmented - it is currently served by approximately 1,600 legal service providers. Legal aid firms are smaller than the average legal firm with an average of 7 qualified solicitors and turnover of £1.5m per year (£0.9m relating to criminal legal aid revenues). Indicative estimates suggests the top 10 players account for only 7 per cent of the legal aid market<sup>3</sup> and only 4 per cent of the criminal legal aid market for duty and non duty cases. The fragmented nature of the market may partially be attributed to the margin pressure exerted on criminal defence providers which is likely to have meant the size of legal aid providers has shrunk as they have searched for short-run efficiencies instead of investing in growth to achieve economies of scale in the future.

In the majority of firms, criminal legal aid work was carried out by senior practitioners, such as Partners and Senior Solicitors. The NAO found in their survey in 2009 that the profile of criminal legal aid practitioners was ageing, with three-fifths of firms established for six years or more believing that the average age of criminal legal aid staff had increased in the last five years.

Criminal legal aid firms are not spread evenly across the country. Over 50% of all criminal legal aid fees for duty and non duty cases are in the following 9 regions: London (26%), Greater Manchester (6%), West Midland (6%), West Yorkshire (4%), Thames Valley (3%), Lancashire (3%), Merseyside (3%), South Wales (3%) and Hampshire (3%). The regions with the largest amount of criminal legal

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<sup>2</sup> Law Society, Legal Services Board, MoJ (July 2012) *A Time of Change: Solicitors' firms in England and Wales*, page 27

<sup>3</sup> Deloitte (May 2013) *The Government's proposed legal aid reforms*



aid fees tend to have larger firms. The average fees per firm from duty and non duty cases in 2012/13 were over £70,000 for the regions with the largest total fees from duty and non duty cases. Regions with the lowest total fee levels typically had average fee levels per firm per year of around £30,000.

Between 2007-08 and 2011-12 a total of 581 suppliers left the criminal legal aid market. Of these, 204 suppliers left due to commercial viability issues and 137 suppliers left due to consolidation with other firms. The remaining 240 firms left for a number of reasons including termination, relocation and retirement. In 2012 31% of current legal aid firms were considering withdrawing from one or more areas of legal aid work in the next 3 years and 14% of firms undertaking criminal legal aid work. The lower the proportion of legal aid clients within a firm, the higher the likelihood it was considering withdrawing from legal aid.<sup>4</sup>

Finally, the sector exhibits the characteristics of a declining market, with reducing profitability and reduced revenue opportunities. It also faces a number of key challenges in attracting new players, namely; the perception that Criminal Legal Aid work is unprofitable, the regulatory requirements and the perception that criminal defence work may not sit well with most businesses' corporate image. In our view, it is therefore unlikely that there will be significant numbers of new entrants. Rather, competition will mainly be from within the current market place.

## 2.2 Profitability

To assess the profitability of firms the total cost of the firm's salaries and its overheads are subtracted from the firm's income. The existing data on the profitability of legal firms tends to either assign a notional salary to equity partners (typically 10% above the highest fee earner) or recognise that the reported profit will cover partner salaries as well as 'super profits'.

When reviewing firm profitability it is also important to recognise that the reported profits are not necessarily available to partners to take out of the practice. Firms are funded by two principal routes – retained earnings and bank finance and part of the partner profits are invariably retained in the business for future investment and working capital.

There is limited data available on the profitability of criminal legal aid firms and so it is not possible to draw definite conclusions. However there is some information available from a recent surveys conducted by Otterburn Legal Consulting of 119 firms across England and Wales in 2013 and a comparable Otterburn Legal Consulting survey from 2011 which form the main data sources for this papers analysis.

According to these surveys, criminal legal aid providers are less profitable than the wider legal services sector<sup>5</sup>. The median profit per partner for legal firms according to the LMS Financial Benchmarking Survey 2012 was £121,000 (before allowance for equity partner salaries) whilst the Otterburn Legal Consulting survey reported it to be £70,000 for criminal legal aid firms.

Legal aid firms have also seen a fall in profitability in the last two years, with profits reported to average £78,000 per firm in 2011, and are due to come under further pressure from the wider reforms to legal aid above and beyond fee reductions to criminal legal aid being considered in this paper. The 10% cut in legal aid fees already announced is also still likely to be working its way through the system and so may only now be starting to be felt in the profit margins<sup>6</sup>.

Table 1 summarises the profitability of firms (after an allowance for equity partner notional salaries) by firm size reported in the 2013 Otterburn Legal Consulting survey. This suggests that the median profit margin of firms is 6%. This data also suggests that the profitability of firms reduces the greater the number of solicitors in the firm.

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<sup>4</sup> Law Society, Legal Services Board, MoJ (July 2012) *A Time of Change: Solicitors' firms in England and Wales*, page 46

<sup>5</sup> Deloitte (May 2013) *The Government's proposed legal aid reforms*

<sup>6</sup> Otterburn Legal Consulting (June 2013) *Price Competitive Tendering for Criminal Defence Services 2013*

Table 1: Margin – current profitability (after allowance for notional salary)

| %                     | Solicitors |      |       |         |
|-----------------------|------------|------|-------|---------|
|                       | 2-5        | 6-12 | 13-40 | Overall |
| <b>Lower Quartile</b> | -5         | 2    | 2     | 1       |
| <b>Median</b>         | 10         | 7    | 6     | 6       |
| <b>Upper quartile</b> | 16         | 15   | 11    | 14      |

Source: Otterburn Legal Consulting (June 2013) *Price of Competitive Tendering for Criminal Defence Services 2013*, Table 9.

The profitability of a firm is driven by the level of fee income and costs of the firm. These two aspects are examined below to provide insight into the drivers behind the levels of profitability observed.

### Fee income

The higher a firm's fee income (assuming costs remain the same) the higher the profit levels of a firm. Similarly, other things being equal, any reduction in fees of the type envisaged by the proposal in question will lead to a corresponding reduction in profits.

Fee income from firms that engaged in criminal legal aid work is derived from their criminal legal aid work and fee income from other practices (both other legal aid practices, such as family law, and private practice). If we assume the fee income from other type of legal work (private and civil legal aid) remain constant, the larger the proportion of a firm's fees that are derived from criminal legal aid the greater the impact on firm's profitability the reduction in criminal legal aid fees.

Over half of firms who conduct legal aid work reported in a recent survey that 50% or more of their clients were legally aided<sup>7</sup>, and just over a quarter reported that 90% or more of their clients were legally aided. These broad proportions are supported by Otterburn Legal Consulting survey in 2011 of 163 firms that found for 56 of the firms legal aid represented more than 75% of their fees, and for 35 it represented under 25%<sup>8</sup>. Firms who conduct a high percentage of legal aid work are likely to have a narrow focus on a single practice.

The NAO's survey of criminal legal aid firms also mirrored these broad proportions as they found on average, an estimated three-fifths of firms' turnover was derived from criminal legal aid. This figure increased to 79% among sole practitioners, whereas the larger the firm the lower the contribution made by criminal legal aid to overall revenues, due to them having a more diverse portfolio.

To allow our analysis to focus on the variable under consideration, we have assumed in this paper that fees for other legal work will remain constant. It is however worth bearing in mind that firms will also incur fee pressure from reductions in civil legal aid which will create additional pressures on firms' profit margins. Legal aid fees have declined in real terms since 1994<sup>9</sup> with additional fee reductions administered by the MoJ since 2007. Median fee income generated by criminal legal aid providers in 2012 has declined by c.7 per cent in 2012 to an estimated £1.0m.

Furthermore, there will be additional fee reductions for criminal legal aid beyond those introduced through the fee cap under consideration in this paper which will reduce profit margins further. These

<sup>7</sup> Law Society, Legal Services Board, MoJ (July 2012) *A Time of Change: Solicitors' firms in England and Wales*, page 27

<sup>8</sup> Otterburn Legal Consulting (February 2011) *Impact of the MOJ Green Papers proposals on legal aid firms*

<sup>9</sup> Deloitte (May 2013) *The Government's proposed legal aid reforms*

include the following forecast reductions (according to MoJ impact assessments) in total criminal legal aid fees:

- a £15m reduction due to the restructure the advocates graduated fee scheme to harmonise the basic fee payable to advocates for guilty pleas, cracked trials and trials at the current cracked trials fee. And reduce fees paid in daily attendance through a combination of an initial reduction and subsequent tapering of the fees;
- a £20m reduction due to reduce fees paid in Very High Cost Crimes (VHCCs) by 30%;
- a £9m reduction due to reduce use of more than one advocate;
- a £4m reduction due to reduce Prison Law Scope; and
- £3m reduction due to change crown Court eligibility threshold

## Costs

The higher a firms cost, assuming fees remain constant, the lower a firms profits.

People costs represent the primary cost of all legal practices (on average 60%). The level of people costs however varies by region, size and specialism. The breakeven point for all firms nationally is £97,348. Given criminal legal aid firms tend to be smaller than the average legal firm the breakeven point will be lower for firms in this sector. It is also likely as many legal aid service providers have been under margin pressure for over a decade, many legal aid providers will have sought to decrease their cost base<sup>10</sup>.

It is however important to recognise any analysis of legal firm costs rests primarily on decisions regarding the number of staff and salary levels of its employees. In a difficult financial climate firms may therefore choose to reduce staff salaries and conversely in periods when the firm is performing well increase salaries. The costs of the firm are therefore not fixed in the same way as costs for expenditure on commodities, utilities and accommodation.

According to the LMS Financial Benchmarking Survey 2012, the salary costs of legal firms generally are higher the bigger the firm gets as a percentage of income. Expenditure on fee earners is also reported to increase the bigger firm gets. The data does however suggest the non-salary overheads tend to reduce by the size of the firm.

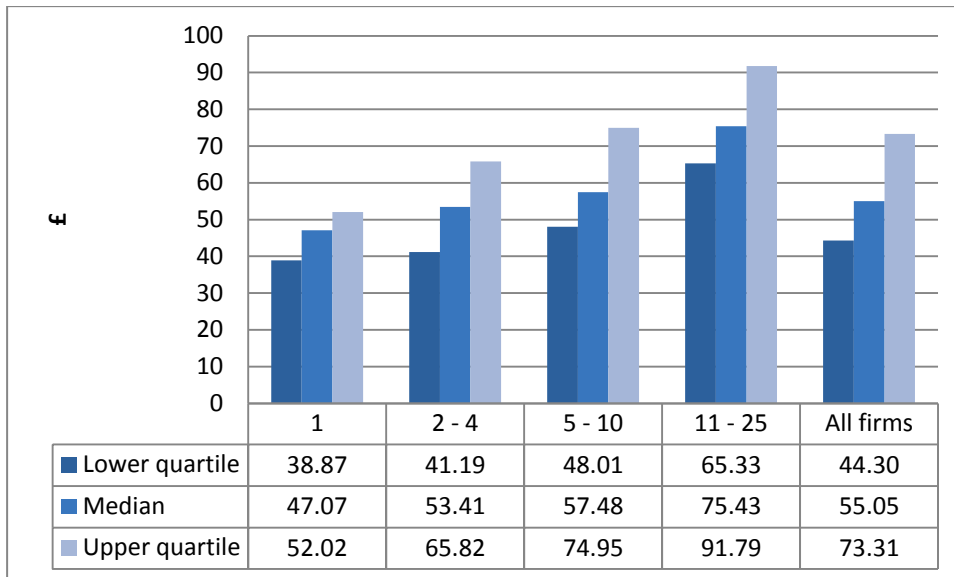
There is little corresponding data available on the total costs or the breakdown of cost specifically for criminal legal aid firms. An Otterburn Legal Consulting report in 2011 suggested that the median cost per hour of criminal legal aid firm was £55.05 (as shown in graph 1). This was based on the salaries and overheads of each firm together with equity partner notional salaries and interest on partner capital. This analysis suggested that the cost per hour of criminal legal aid firms increased as they grew in size.

There are a number of explanations for why larger firms may have higher costs than smaller firms. Larger firms often have higher overheads to operate the business and a higher salary bill for the increased number of senior level practitioners working on criminal legal aid. We also noted earlier that a higher proportion of smaller firms derive 100% of their revenues from criminal legal aid, this increased specialist focus may have resulted in firms developing more efficient working practices, allowing increased profit margins to be achieved.

### Graph 1: Firm cost per hour

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<sup>10</sup> Deloitte (May 2013) *The Government's proposed legal aid reforms*



Source: Otterburn Legal Consulting (February 2011) *Impact of the MoJ Green Papers proposals on legal aid firms*

## 2.3 Liquidity

Whilst profits are important the key requirement in any firm is cash. Firms are funded by a combination of capital from the partners and borrowings, normally from banks. Both of these sources of funding have come under pressure in recent years. Reduced levels of liquidity reduce firms ability to invest and ultimately can lead to insolvency. An analysis of firms liquidity is therefore important as it will act as a constraint on the sustainable level of profits.

In 2011 the median capital per equity partner was £70,000 however that was reported to have fallen to £40,000 in 2013. This is likely to be largely due to reduced profitability. The comparable figure for 2012 LMS survey was £176,000 per equity partner. In terms of access to borrowing, over the last five years there is reported to have been a change in attitude on the part of the banks to lending to law firms, especially those with an ageing equity profile and those with high levels of income. The 2013 Otterburn Legal Consulting survey suggests there has been slight improvement in the bank position per equity partner recently and in firms available finance headroom (comparing bank balance to their facility).

# 3 IMPACT OF REDUCTION IN FEES

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PA Consulting was asked to undertake a short assurance exercise assessing the impact of the proposed criminal legal aid fee reductions on the financial sustainability of the current provider base. Within this analysis we were specifically tasked with making an assessment of an 8.75% reduction in fees if it were introduced in February 2014 and a further 8.75% reduction in fees if it were introduced in May 2015.

## 3.1 Options available to firms in response to fee reductions

The ability of firms to sustain fee reductions will depend on the following factors:

- **the scope for the firm to reduce its costs by implementing efficiency savings** (either from economies of scale or economies of scope)
- **the scope for the firm to reduce its salary costs per case** – either by reducing salaries of existing solicitors and/or using less qualified staff
- **the proportion of the firms revenue sources that are derived from criminal legal aid** (i.e. how big a proportion of the firm's profits are derived from criminal legal aid), however this will only impact short run sustainability as in the long run firms will withdraw if the work is not profitable in its own right.
- **the level of profitability of firms** (i.e. the extent to which reduced fees can simply be absorbed by reduced profits).

We assess the potential for each of these responses in turn below.

### Scope for delivering efficiency savings

The MoJ Consultation paper 'Transforming Legal Aid: Delivering a more credible and efficient system' suggested two potential routes for firms to reduce their costs to deliver efficiency savings – efficiency savings through economies of scale and economies of scope.

#### *Economies of scale*

The consultation paper suggests economies of scale could be realised through reduced overheads per fee-earner (including insurance), the introduction of more efficient working practices and likely greater capability to invest in ICT that supports more effective ways of working (such as digital files etc.). There is however mixed evidence available to support this assumption.

The evidence in support includes:

- findings from the Carter review (2006) which indicated significant (24%) amounts of unproductive time;
- examples from other parts of the legal services market where cost reductions have been achieved through standardisation outcomes a change in workforce with higher reliance on paralegals, and automation. e.g. IT outsourcing is related to a highly significant 17% higher productivity compared to firms not outsourcing IT<sup>11</sup>;
- 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 22% of these managed to gain law related work e.g. as a paralegal);
- as headcount increases, process improvement and streamlined back office operations have more potential in driving efficiencies in the cost base of these law firms. The current duty solicitor scheme is reported to encourage over-capacity and is widely regarded as in need of reform; and
- there are potential savings to be realised from CJS efficiency reforms (such as digital working) that could translate into cost reductions for legal aid providers

The evidence against:

- there does not appear to be a relationship between size of firm and cost per hour of criminal legal aid firms currently;
- the majority of micro firms are reported to have already reduced their overhead cost base to a minimum and have minimal scope remaining for further reductions<sup>12</sup>;
- any commoditisation of back office processes may have already been implemented by the larger suppliers. 46% practices have already outsourced IT infrastructure and development;
- many firms will have to make redundancy payments that may wipe out already low capital reserves. Firms may not have sufficient cash to make the redundancy payments;
- having 90% or more legal aid clients was not associated with significant differences in productivity in the log-gamma model. Instead it would appear that other variables (for example, areas of work associated with legal aid) were better able to explain the association;
- there is limited ability to capitalise on savings made in other areas by the nature of criminal legal aid work - which will continue to require face-to-face work. Survey of 2000 firms found having 50% or more work in crime or immigration related to significantly lower productivity of 33% and 37% respectively compared to other firms<sup>13</sup>;
- the ability of incumbent legal aid providers to move towards new business models may be constrained by a lack of access to capital to invest in new models and supporting infrastructure;
- at least in the short run, existing suppliers will be locked into their current arrangements in respect of staffing, premises, IT support, car leasing arrangements and other overheads; and
- mergers are also not likely to happen in the short run but may over time. It is not untypical for a merger between two firms to take up to a year, from initial conversations to registration of the new entity and being ready to operate.

### *Economies of scope*

The proposed model also asserts that economies of scope can be created by the removal of client choice. Under the current model a high proportion of defendants attending police stations opt to use their own solicitor in preference to the duty solicitor. By removing choice, economies of scope may be created through removing the duplication of effort of two different solicitors reading the same case information at the police station and magistrates' court.

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<sup>11</sup> Law Society, Legal Services Board, MoJ (July 2012) *A Time of Change: Solicitors' firms in England and Wales*, page 30

<sup>12</sup> Deloitte (May 2013) *The Government's proposed legal aid reforms*

<sup>13</sup> Law Society, Legal Services Board, MoJ (July 2012) *A Time of Change: Solicitors' firms in England and Wales*, page 28

However, this reasoning ignores the economies of scope achieved by a client retaining the same representative over a number of matters, whether over a short period of time or a longer number of years. The evidence for this as a driver of cost reduction therefore appears limited to us.

Given the balance of evidence both for and against the potential for economies of scale and scope, no efficiency savings will be assumed in the impact analysis of the proposed fee reductions in section 3.2.

### **Reduce in costs from salary reductions**

As outlined in section 2.2, salaries are the primary cost for legal practices. One option therefore available to firms facing a reduction in fees is to offset their reduction in revenue with reductions in staff salaries or use less qualified staff. Analysis presented by Otterburn Legal Consulting suggests to offset a 17.5% cut in fees salaries in the criminal department would need to be cut by 24%. The ability to implement salary reductions will however be limited by employee contracts and willingness of employees to accept roles on reduced terms. There will come a point when firms will struggle to fill positions if it continually reduces salary levels. Similarly there will be impacts on the quality of solicitors in the criminal legal aid market relative to alternative areas of law.

### **Alternative revenue sources**

Another option available to firms in response to the reduction in fees is to diversify their revenue streams away from criminal legal aid firms into other areas of practice. Other things being equal, the smaller the percentage of a firm's revenue from criminal legal aid the better able the firm will be to sustain a reduction in criminal legal aid fees in the short run.

In the medium term firms would not be prepared to subsidise criminal legal aid and are likely to withdraw from the criminal legal aid market all if the margin is not sufficient. Diversifying revenue stream therefore only increase the sustainability of the fee reductions in the medium term.

Some firms may choose to maintain a legal aid capability to either provide a wider set of services to their clients and/or seek to use the legal aid work to lever other types of legal advice.

### **The profitability of firms**

It may be possible to sustain the fee reductions simply by absorbing by reducing profits the firm receives. The ability of firms to do this however will be constrained by the banks propensity to lend. The lower the propensity to lend the higher the profits the firm require to fund working capital and firm investments).

## **Analysis of impact of fees reductions**

Given the analysis set out in this paper we suggest it would be reasonable for an analysis of the impact of fees reduction to rest on the following assumptions:

- 50% of fee will be derived from criminal legal aid cases. (Note we will also assess the impact on firms with 90% of their revenue from criminal legal aid work and 25% of revenue from criminal legal aid work);
- the fee reductions for planned for other areas of civil and criminal legal aid are not factored in;
- the fee level of private sector fees remain constant;
- criminal legal aid fees are assumed to relate to duty and non duty cases (not VHCC or magistrates' court representation); and
- cost efficiencies cannot be achieved in the short run;

- salaries are fixed (we realise in reality there is likely to be room for some reduction here but we have not seen any evidence that CLA salaries are high than the market rate for other legal firms); and
- the current profit margin of criminal aid firms will be assumed to be 6%

**Would an 8.75% reduction in fees be sustainable if it were introduced in February 2014?**

Based on the limited data available, Table 2 suggests an 8.75% reduction in criminal legal aid may be sustainable for the firms with median levels of profitability and above (assuming only 50% of a firm's revenue is derived from criminal legal aid). However, as noted above these profit margins do not take into account the other reforms to legal aid which will also affect profitability.

In this scenario, an 8.75% reduction in fee levels, is expected to reduce to firms' median margins to 1.6%. It is likely some firms may decide this profit level whilst positive is not sufficient to sustain them in the market due to the impact on the levels of available working capital. Similarly, even if firms do not have liquidity constraints, they may still take the view there is insufficient incentive/ returns to remain in the market.

The data suggests the smaller firms are better placed to sustain the reductions in revenue than larger firms. This conclusion is supported by the findings of the NAO in 2009 who found the stated profitability of criminal legal aid work was lowest among larger firms: sole practitioners cited a 29 per cent profit level on average, compared to an 11 per cent average profit cited by medium sized firms (13-40 solicitors).

As criminal legal aid fees are not spread equally across the country, certain regions are likely to be more affected by the reductions in fees levels than others. London, Greater Manchester, West Midlands and West Yorkshire are likely to be most affected.

Table 3 and 4 run two further scenarios, providing sensitivity tests for different assumptions regarding the level of reliance firms have on criminal legal aid revenues. As you would expect, firms who have a greater reliance on criminal legal aid revenues struggle more to maintain profit levels than those who have a more diverse set of revenue streams.

**Scenario 1 (central scenario – assumes firm has 50% of revenue from criminal legal aid fees):**

*Table 2: Margin after 8.75% reduction in criminal legal aid fees (after allowance for notional salary)*

| %                     | Solicitors |      |       |         |
|-----------------------|------------|------|-------|---------|
|                       | 2-5        | 6-12 | 13-40 | Overall |
| <b>Lower Quartile</b> | -9.4       | -2.4 | -2.4  | -3.4    |
| <b>Median</b>         | 5.6        | 2.6  | 1.6   | 1.6     |
| <b>Upper quartile</b> | 11.6       | 10.6 | 6.6   | 9.6     |

*Source: PA Consulting analysis, margin data from Otterburn Legal Consulting (June 2013) Price of Competitive Tendering for Criminal Defence Services 2013, Table 9.*

**Scenario 2 (assumes firms have 25% of revenue from criminal legal aid fees):**

*Table 3: Margin after 8.75% reduction in criminal legal aid fees (after allowance for notional salary)*

| %                     | Solicitors |       |       |       |
|-----------------------|------------|-------|-------|-------|
|                       | -20.8      | -13.8 | -13.8 | -14.8 |
| <b>Lower Quartile</b> | -7.2       | -0.2  | -0.2  | -1.2  |



|                       |      |      |     |      |
|-----------------------|------|------|-----|------|
| <b>Median</b>         | 7.8  | 4.8  | 3.8 | 3.8  |
| <b>Upper quartile</b> | 13.8 | 12.8 | 8.8 | 11.8 |

Source: PA Consulting analysis, margin data from Otterburn Legal Consulting (June 2013) Price of Competitive Tendering for Criminal Defence Services 2013, Table 9.

### Scenario 3 (assumes firms have 90% of revenue from criminal legal aid fees):

Table 4: Margin after 8.75% reduction in criminal legal aid fees (after allowance for notional salary)

| %                     | Solicitors |      |       |         |
|-----------------------|------------|------|-------|---------|
|                       | 2-5        | 6-12 | 13-40 | Overall |
| <b>Lower Quartile</b> | -12.9      | -5.9 | -5.9  | -6.9    |
| <b>Median</b>         | 2.1        | -0.9 | -1.9  | -1.9    |
| <b>Upper quartile</b> | 8.1        | 7.1  | 3.1   | 6.1     |

Source: PA Consulting analysis, margin data from Otterburn Legal Consulting (June 2013) Price of Competitive Tendering for Criminal Defence Services 2013, Table 9.

### Would further 8.75% reduction in fees if it were introduced in May 2015?

Table 5 shows a further 8.75% reduction may only be achievable only for the most efficient firms (only upper quartile firms and median 2-5 firms).

Table 6 and 7 run two further scenarios, again providing sensitivity tests for different assumptions regarding the level of reliance firms have on criminal legal aid revenues. Table 7 shows no firms who have a greater reliance on criminal legal aid revenues (90% of revenue from criminal legal aid) achieve a positive profit margin at this level of fee reduction, apart from the most profitable firms with 2-5 solicitors. Firms for which criminal legal aid represents only a minority stake of their overall revenue (25% of revenue) fair better as you would expect and firms with median and upper quartile levels of profits continue to earn margins of between 1.6- 5.6%.

### Scenario 1 (central scenario – assumes firm has 50% of revenue from criminal legal aid fees):

Table 5: Margin after 17.5% reduction in criminal legal aid fees (after allowance for notional salary)

| %                     | Solicitors |      |       |         |
|-----------------------|------------|------|-------|---------|
|                       | 2-5        | 6-12 | 13-40 | Overall |
| <b>Lower Quartile</b> | -13.8      | -6.8 | -6.8  | -7.8    |
| <b>Median</b>         | 1.3        | -1.8 | -2.8  | -2.8    |
| <b>Upper quartile</b> | 7.3        | 6.3  | 2.3   | 5.3     |

Source: PA Consulting analysis, margin data from Otterburn Legal Consulting (June 2013) Price of Competitive Tendering for Criminal Defence Services 2013, Table 9.

### Scenario 2 (assumes firms have 25% of revenue from criminal legal aid fees):

Table 6: Margin after 17.5% reduction in criminal legal aid fees (after allowance for notional salary)

| % | Solicitors |  |  |  |
|---|------------|--|--|--|
|---|------------|--|--|--|

|                       | 2-5  | 6-12 | 13-40 | Overall |
|-----------------------|------|------|-------|---------|
| <b>Lower Quartile</b> | -9.4 | -2.4 | -2.4  | -3.4    |
| <b>Median</b>         | 5.6  | 2.6  | 1.6   | 1.6     |
| <b>Upper quartile</b> | 11.6 | 10.6 | 6.6   | 9.6     |

Source: PA Consulting analysis, margin data from Otterburn Legal Consulting (June 2013) Price of Competitive Tendering for Criminal Defence Services 2013, Table 9.

### Scenario 3 (assumes firms have 90% of revenue from criminal legal aid fees):

Table 7: Margin after 17.5% reduction in criminal legal aid fees (after allowance for notional salary)

| %                     | Solicitors |       |       |         |
|-----------------------|------------|-------|-------|---------|
|                       | 2-5        | 6-12  | 13-40 | Overall |
| <b>Lower Quartile</b> | -20.8      | -13.8 | -13.8 | -14.8   |
| <b>Median</b>         | -5.8       | -8.8  | -9.8  | -9.8    |
| <b>Upper quartile</b> | 0.3        | -0.8  | -4.8  | -1.8    |

Source: PA Consulting analysis, margin data from Otterburn Legal Consulting (June 2013) Price of Competitive Tendering for Criminal Defence Services 2013, Table 9.

## 3.2 Recommended next steps

- In the remaining time of our work, conduct further analysis of available research into profitability of criminal legal aid firms
- Conduct further analysis on the potential for efficiency savings and salary reduction in criminal legal aid firms
- Gather further data on the fee profile (i.e. split between civil, criminal and private fees) of criminal legal aid firms.
- Produce detailed process maps to understand where areas of suppliers' current processes can be streamlined and changed to understand the extent to which process inefficiencies exist.

# APPENDICES

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|   |                              |
|---|------------------------------|
| A | SUMMARY OF EVIDENCE REVIEWED |
|---|------------------------------|

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# A SUMMARY OF EVIDENCE REVIEWED

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## Details of Paper

Deloitte (May 2013) The Government's proposed legal aid reforms

Otterburn Legal Consulting (June 2013) Price Competitive Tendering for Criminal Defence Services 2013

Law Society, Legal Services Board, MoJ (2012) A Time of Change: Solicitors' firms in England and Wales

The Law Society (2012) LMS Financial Benchmarking survey

Otterburn Legal Consulting (February 2011) Impact of the MOJ Green Papers proposals on legal aid firms

Ministry of Justice (2006) Lord Carter Review of

## Summary of purpose and methodology

- Report produced for Law Society to inform their response to MoJ consultation.
- Based on input from the Law Society and other stakeholders, published studies and own experience.
- Report produced for Law Society to inform their response to MoJ legal aid consultation with regards to competitive tendering for criminal defence services.
- Based on interviews and survey of 119 firms across England and Wales.
- Report commissioned by Law Society to provide a benchmark of the profession.
- Conducted survey of 2,007 solicitor firms across England and Wales, ranging from sole practitioners to large corporate firms in May 2012.
- Annual Financial Benchmarking survey – 166 practices responded to the survey
- Report for Law Society to assess the impact on firms of the Ministry of Justice's (MoJ) green Paper proposals in respect to legal aid
- Questionnaire 163 firms completed (8% of firms with civil contracts)
- Sample may under-representative of sole principals and over representative of firms with 2-10 partners if legal aid firms follow general distribution of law firms
- 1/3 participants legal aid accounted for over 75% fees, and for 1/5 it accounted for under 25% fees. Legal aid represented just under 50% of the combined fees of the firms.
- Lord Carter's report on the review of legal aid procurement – follows a year of analysis and consultation. Paper provides an analysis and set of recommendations.

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**Corporate headquarters**  
123 Buckingham Palace Road  
London SW1W 9SR  
United Kingdom  
Tel: +44 20 7730 9000

[paconsulting.com](http://paconsulting.com)

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