



Single purchaser market: the procurement of criminal defence services (CDS)

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By LECG on behalf of the Law Society

This paper provides some views on the potential effect of government monopsony on the procurement of legal aid services. Monopsony is a market situation where there is only one buyer. In this case that is the Legal Services Commission. This paper addresses the general question of whether the existence of a monopsony might rule out effective 'market based' provision of services. In particular, it reviews the implications of monopsony for the proposed use of best value tendering (BVT) for criminal defence services (CDS). With some adjustment the comments should also apply to the procurement of other types of legal aid services.

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1. Concerns about the impact of monopsony on the supply of legal aid services

This paper addresses the question of whether, because the government is the monopsonist purchaser of legal aid services, there can still be effective competition in the supply of legal aid services. According to arguments that have been made, the organisation of the market is determined by the government which can dictate the price and other terms under which services are procured. This is especially a concern for competitive best value tendering, with repeated contract cycles. According to these arguments:

- Suppliers have no alternative buyers, as they would in a 'competitive' market, so must accept the price and terms of the government monopsonist.
- It is not possible to have real competition for services since the purchaser determines not just the price and volume but also can impose limits on the number of firms able to bid, the size of bid that will be accepted, quality targets, and other restrictions which limit the suppliers' ability to compete effectively.
- Uncertainties in the arbitrary exercise of monopsony power and frequent changes in policy increase risks to providers. These raise costs and make it difficult for firms to plan their business.
- In repeated contract cycles the period of the cycle may not coincide with the planning horizon of the firms, which may be unable to recover the cost of their investments in capacity (i.e., the contract period may be too short for a firm to recover a full return on its investment, with no assurance that a second contract will be awarded next period). This also increases risks and costs.

It is claimed that this limits suppliers' ability to organise their business in the most efficient way, hence restricting competition and threatening the supplier base. On this basis it is argued that BVT is fundamentally unworkable due to the structure of the market and the government should abandon it.

2. Theoretical analysis of monopsony and implications for competition

Some background on how monopsony works may help put this in context. We then consider the implications for competition.

2.1 Market theory

Monopsony is a type of market organisation with a single buyer and many sellers. There are many different types of market structure, from perfect competition (many buyers and many sellers of a homogeneous product), through various forms of imperfect competition (few buyers and/or sellers of partially differentiated products), to monopoly (single seller and many buyers) and monopsony (single buyer and many sellers). The main distinction is how much 'market power' individual buyers and sellers have to set prices and volumes.

In a **perfectly competitive** market no individual buyer or seller has control over prices, which are set by competition in the market place. Competition between sellers drives prices down until the market clears (no more is demanded or supplied at that price). In equilibrium this also means that no supplier makes above-normal profits ('normal profits' are just enough to cover all costs plus a normal return on investment), otherwise it is undercut by competitors. A perfectly competitive market is 'socially efficient' in that it produces the maximum output for which demand exceeds total resource costs.

In a **monopsony** the single buyer can set prices (or volumes) without having to worry about being outbid by another buyer offering a higher price. However, the monopsonist is still

constrained by the quantities that suppliers are willing to provide at a given price and by how much it is itself willing to pay for a given quantity. It may set prices or volumes but, in the long term, not both. The many sellers compete with each other to sell services at a given price. For a particular volume of services being bought, competition between suppliers determines a market clearing price. Different suppliers bid down the price until no one is prepared to offer more than the required total volume at that price.

In equilibrium all suppliers should make at least 'normal profits'. The more efficient suppliers may do better than this and make above-normal profits, depending partly on whether all firms face the same market clearing price or whether in a tendering process those that bid lower prices are held to their individual bid prices. If all firms are awarded work at a single 'clearing' price then the more efficient firms with lower per unit costs make positive profits. This is because the price at which the market clears is set by the marginal firm (highest per unit cost). If instead firms are held to their individual bid prices then firm profits would be those implied in their bids, which should be at least a 'normal profit' and possibly more. Which situation applies depends on the pricing rules for the tendering process and the bidding strategies of the firms.¹ In either case, firms with higher costs do not supply.

This assumes that firms only bid prices down at most to the point at which all their costs are covered (including variable costs plus fixed costs and return on investment). The conditions for this and the possible effect of short term 'over supply' on prices are discussed below.

The main text book problem for monopsony (the mirror image of monopoly) is that the monopsonist may limit volumes and prices below the levels that would be reached in a perfectly competitive market – this lowers the monopsonist's average costs per unit and increases the volume of services it obtains for a given total cost.² This is socially inefficient as more services could be provided below the cost of production if prices were higher. Even so, those suppliers still in the market are profitable.

A more serious problem in the current case is that, facing its own budget constraints, the monopsonist may be tempted to set prices for the services it buys still lower, below the market clearing price at that volume, at levels that may not cover fixed costs for all firms.³ Rather than exit the market firms may continue to provide services as long as their variable costs are covered, even though this may not cover their fixed costs or provide an adequate return on investment. But this can only be a short term ploy. In the long term the supplier base will shrink as the higher cost firms leave the market and are not replaced:

- A firm thinking of entering the market will decide not to do so if it cannot earn a normal market return on the investment needed to enter.
- Existing suppliers (whose investments are sunk but who must still cover fixed costs) will also eventually leave if they have better alternatives or if their earnings no longer cover fixed costs.
- The market eventually reaches equilibrium in which fewer services are supplied at the enforced lower price.

¹ The design of the tendering rules affects incentives for firms to bid their true costs. The details of the BVT system for CDS are still being developed. They are outlined in Carter Report (2006), p. 58-59, paras 61-64 and for very high cost cases at p. 80-82, paras 75-90.

² By contrast, in a monopoly the monopolist restricts sales volumes in order to raise prices and total revenues. The motive and effect of restricting volumes by monopolists and monopsonists are similar.

³ Alternatively it might restrict volumes so that short term 'cut throat' competition between firms for a limited amount of work could achieve the same result.

2.2 Implications for monopsony and competition

Based on the above discussion, we can make some observations on the relationship between monopsony and competition. These are summarised as follows:

- There is nothing in theory that says that there cannot be effective competition between suppliers with a monopsonist buyer or that this cannot lead to a market structure that is efficient (in the sense that a given volume of work is supplied at the lowest market price consistent with firms earning at least normal profits). The key condition for efficiency is that the supply side maintains truly competitive conditions (including many suppliers, low entry costs, equal access to information and resources).
- Government monopsony is a fact of the market for legal services. The question is not whether a monopsony can be avoided but what form of market organisation is more effective in terms of the policy objectives of providing sustainable quality services at lowest cost.
 - Two main candidates for organising procurement for legal services are some form of (a) administered prices (as currently), and (b) best value tendering (BVT).
 - In theory both could work effectively.
 - In practice, both have advantages and drawbacks, and which is more effective depends on the details of how the procurement system is designed and implemented.
 - Information on firms' true costs is important. With administered prices the administrator needs full information on firms' costs to set efficient prices, costs which only the firms know accurately and which vary by circumstance; in best value (price competitive) tendering – if it works smoothly – firms 'reveal' their costs in the bids they make.⁴
 - In best value tendering firms should be sure of at least 'normal profits' in the bids they make, whereas in an administered system profits may be squeezed if prices get out of line with costs over time.
 - Widely recognised problems with the current system, such as funding or incentives for efficiency, have led to the proposals for an alternative system.⁵
- The policy challenge for best value tendering to work is to ensure that competitive conditions exist on the supply side. If these conditions are adequately addressed the existence of monopsony should not in itself be a barrier to meeting objectives of a sustainable high quality supply at the lowest cost.
- There are positive aspects of having a single purchaser. The single government purchaser provides stable and predictable demand for services, which if managed effectively by the government provides a good basis on which firms can plan their business. This may be compared with some highly competitive markets (from high

⁴ Arguments for the use of competition to reveal firms' true costs are made in the Frontier Economics Report, "A market analysis of legal aided services provided by solicitors", December 2003, p. 5. <http://www.dca.gov.uk/laid/frontier-solicitors-rpt.pdf>

⁵ A main potential advantage for competitive tendering is that price competition between suppliers forces them to reveal their true private costs to ensure they bid low enough to win a contract. This also provides incentives to reduce costs. Administered prices are set without knowing firms' true private costs and so may be out of line with true costs.

technology to agriculture) in which demand and prices fluctuate excessively and make planning hard.⁶

- There are important provisos for the impact of government monopsony:
 - The monopsonist should avoid 'regulatory risk' problems of changing policy unpredictably in ways that threaten the value of long term investments made by suppliers.
 - Perhaps most important is that government should be prepared to accept outcomes generated by market competition, if it is clear that competitive supply conditions have been achieved. If it does not do so then we are back to administered prices.
 - The influence of the government is effective in the detailed design of the BVT process; this should be designed to ensure competitive conditions and meet the policy objectives for legal aid services.
- The transition from the current administered price system to a system with block contracting, fixed prices and ultimately BVT is critical and should be organised sensitively to avoid significant damage to the supplier base.
- BVT is used extensively and successfully in many areas of government and private procurement, such as in out-contracting health services support, transport, construction, IT, consulting and facilities. This works most effectively for industries where there is a competitive supplier base, also one that is not tied to the single source of work and where new entry is possible.

3. Implications for Carter proposals for CDS

Most of the implications for BVT for the Carter proposals for CDS have been discussed above. There are some specific arguments that may be mentioned.

First, it is suggested that the contract period should be longer than the three to five years proposed by Carter, and at least five years to enable firms the certainty to plan ahead and recover their investments needed to build capacity to undertake a bid. There is a point here that firms should be able to recover the investment needed to enter the market, as a condition for ensuring competition. However, the duration of the contract has to be balanced against the problem that the longer the period the less likely that there will be qualified bidders other than the incumbents to compete for the next contract cycle. Also a poor performer should face the possibility of being removed sooner rather than later. The length of the contract period must balance many different aspects.

A main problem for continuing competitive conditions for tendering is ensuring effective potential entry for tenders, whether this is from existing suppliers, suppliers from other contract areas, suppliers building custom via own solicitor work or entirely new entrants. The length of the contract period and recovering entry costs is only part of this equation.

Second, arguments may portray an ideal situation in which there is not a single purchaser but many alternative purchasers competing in the market, giving the suppliers a choice and the ability to seek the most favourable offer rather than having prices and market conditions dictated by the monopsonist. The main objection to this view is the fact that government funding of legal aid defines the market and is unlikely to be replaced by multiple sources. If these arguments are intended to describe a market that approximates perfect competition, this is not a particularly relevant model for legal aid. The conditions of perfect competition

⁶ In some cases, such as agriculture, marketing boards may be set up by producers to stabilise demand and ease the plight of suppliers. Marketing boards tend to be short lived, and have generally gone out of favour, as the board prices tend to get out of line with market prices over time (as may have happened in legal aid).

(many firms, full information, homogeneous product, no entry or exit costs) do not apply. Also in perfect competition firms can make at most normal profits and have little incentive to invest in becoming more efficient (since profits will be competed away).

Third, it is suggested that specific problems mentioned by the Carter Report as contributing to excessive costs, such as travel and waiting costs, are not sufficient cause to change the whole procurement system, but could be handled within the current system. This may be true in a way. However, if we start from underlying problems such as funding or incentives for supplier efficiency, and the long term sustainability of a high quality supplier base, it should be clear that travel and waiting costs are only an incidental (though not insignificant) part of the problem. A basic issue is the long term health of the supplier base. Changing the procurement system to one that encourages competition between suppliers, coupled with the opportunity for firms to earn realistic 'market determined' profits, may be a way to achieve this. This offers hope which the current administered system may not. The challenge is to get the new system right. In theory it could work effectively, and the fact of a monopsonist purchaser does not stop this.

Fourth, the government monopsonist sets the terms for market competition via the rules governing the BVT tendering process. These define the market structure and behaviour, including the boundary areas, qualified suppliers, geographic restrictions, tendering procedures, contract size and duration, price structures and others. Great care will be needed in designing this system so that it has the best chance of ensuring continuing competitive supply conditions and is capable of meeting the policy aims for legal aid services.

4. Conclusion

Monopsony, with a dominant government purchaser, is a feature of legal aid services. In itself monopsony does not mean that the supply of CDS services cannot be competitive and efficient. A challenge for the proposed system to be an improvement over the current system will be to ensure that the market is defined in such a way that it is and will remain competitive with a healthy supplier base. This will depend very much on how the rules for BVT are designed and implemented.

In summary:

- There is nothing in theory about the fact of a single purchaser that would make BVT unworkable.
- Key conditions for an efficient and therefore effective competitive market are that there should be a sufficient number of suppliers, low market entry costs and equal access to information and resources.
- BVT is used extensively and successfully in many areas of government, e.g. health services support, construction, IT, transport.

However, to make BVT work in the context of legal aid the Government should:

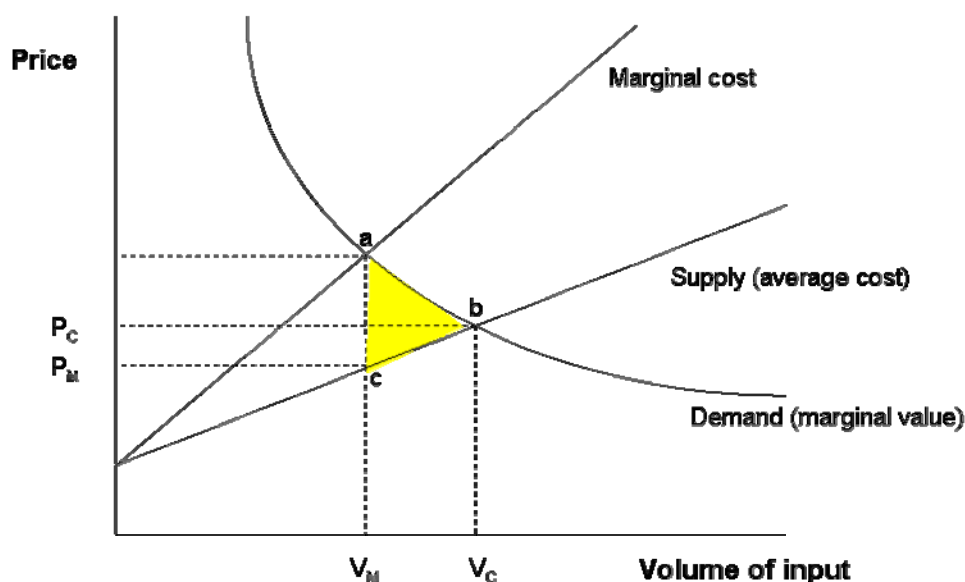
- Be prepared to accept the prices generated by market competition, resisting the temptation to revert to centrally administered prices.
- Avoid abrupt policy changes that would threaten the long term investment of suppliers.
- Manage the transition period, which will include fixed prices and block contracting, very carefully to avoid de-stabilising the supplier base.

5. Appendix: Competition in a monopsonistic market

5.1 Market diagram

The market position for a monopsonist is shown in the following diagram. A perfectly competitive market would operate at volume V_C and price P_C . A monopsonist restricts volume to V_M , which maximises its value (marginal cost of the input equals its marginal value to the buyer) at which the market price is P_M . The social welfare loss is represented by the area of the triangle abc between V_M and V_C .

Figure 1: Monopsony pricing



5.2 Conditions for efficient supply

There is no reason in theory why a monopsonistic market should not be considered competitive in important respects, with effective competition between suppliers for a given total volume of work. Competition moves prices downwards to the point where the marginal firm is just able to cover all its costs and the lower cost firms make positive profits. This has an advantage that only the firms themselves know their own costs (which are likely to vary from firm to firm and location to location) and these costs are revealed in the competitive process.⁷

However, there are important conditions for this. The most important of these are: (a) there should be sufficient number of firms for effective competition on the supplier side, (b) there

⁷ This partly reflects the arguments in the Frontier Economics Report: "A procurement system that led to suppliers revealing the prices that they would be willing to accept, and that remunerated suppliers on the basis of these prices, would therefore be likely to improve the value for money secured by the legal aid scheme. The most obvious way that this could be achieved would be through the introduction of competition. This could involve competition for individual cases, sets of cases or for contracts." Frontier Economics (2003), "A market analysis of legal aided services provided by solicitors", Department For Constitutional Affairs And The Legal Services Commission, December 2003, p. 5. <http://www.dca.gov.uk/laid/frontier-solicitors-rpt.pdf>

should not be significant entry or exit costs, and (c) services being provided should be homogeneous. In particular if there are sunk costs of entry to participate in the market then competition may be restricted in two countervailing ways. Firms already in the market may bid down or accept prices below their full costs in the short term, foregoing a full return on their sunk investments in entry, rather than leave the market. They may also compete by lowering quality. Conversely, new firms will not enter the market unless they can be sure to recover the entry investment, and supplier competition may be limited in the long term if they cannot do so.

This makes the options open to suppliers other than participating in the monopsony market very important. If firms have profitable options in other markets then they will not accept lower prices in the monopsony market, which must pay rates competitive with other sectors. If suppliers do not have such options or must invest significantly in retraining or establishing a business to exit and move to other types of work, then there is the potential for the monopsonist to squeeze prices. As above, such a policy by the monopsonist is short term and counterproductive, as it will not ensure a sustainable high quality supplier base in the long term and only stores problems for later.

More to the point, if the monopsonist allows firms to make a normal return (judged by comparison with alternative sectors) and recover their entry costs then there should be effective competition on the supply side and efficient pricing (in which a given volume of services are provided at the lowest market clearing price at which all firms make normal profits).

In this way, the monopsony market would behave in the same way as if total demand were fixed but made up of demand from many independent and competing buyers, each one of which is price insensitive. All that is basically required is that the monopsonist accepts the prices generated by competition between sellers for the given amount of work.

5.3 Comparing administered and competitive pricing systems

Monopsony is an unavoidable feature of legal aid. It is a fact of the market that for services such as legal aid there is a single government buyer. The question is not whether we would prefer to have a different structure with many buyers competing with each other but rather how we should organise the market so that the outcome is the most economically efficient way possible to meet the aims of policy.

Problems with the current administered price system for legal services are well known. In part they are as much a consequence of the government monopsony and the level at which it sets prices and conditions as are the potential problems with BVT. A key disadvantage with administered prices is that for a variety of reasons administered prices may not reflect suppliers' true costs and by being set at low levels have resulted in low profits for legal aided firms, especially in CDS where firms are specialised and have few alternative sources of business in the short term. Thus, administered prices also involve many risks to suppliers similar to those that may apply to BVT.

Potential problems with BVT are less well known but some indications are given by the conditions needed for a competitive supply market. An advantage of using market competition to select suppliers (even with fixed prices) is that this can select out the most efficient firms. Using BVT to set prices may in theory mean that prices set by open competition reflect true costs and permit firms to make normal 'market based' profits. The competitive tendering process also means more information is available to both sides on which to base prices and plan supply.

However, for the BVT system to work effectively there are significant conditions needed to ensure that competitive conditions are maintained on the supply side (see above).

Competitive supply conditions depend, amongst other things, on ensuring that there are sufficient number of qualified firms able to compete for business and that firms are able to earn enough to cover all their costs over the long term, including a normal return on investment. This depends very much on the details of how the contracting system, such as the BVT auction, is designed. This is likely to include how large a contract area, how many firms are awarded contracts, what size bids are accepted, how much own solicitor work is allowed, how long a contract period, what regional or other variations in prices are allowed, and others.

A particular question for the design of the tendering system is whether successful firms are awarded the actual prices they bid or all firms are awarded work at a single market clearing price, which for some firms will be above their bid price. Which is chosen affects incentives for firms to bid at their true costs.

The most important condition, however, is that if competitive conditions prevail, the monopsonist should accept the prices generated by BVT and not try to lower them. It is in both the government's and suppliers' interests to ensure a sustainable and competitive supplier base.

5.4 Regulatory risk and uncertainty

There are also potential positive advantages in having a monopsony buyer. Dealing with a single entity buyer may be simpler and in many ways more predictable than having many customers. Barring the potential for sudden change that is sometimes the mark of policy, the single buyer can introduce more stability into the market; prices and volumes of work are not subject to the same fluctuations that private markets often are. For example, in agriculture where there are particularly strong variations in prices due to shifts in supply and demand, buying boards may be set up to stabilise prices. This advantage requires the government to maintain a consistent policy over the long term and also depends on specifics such as the length of contract period. Uncertainty over potential changes in the procurement rules raises risk and costs for suppliers. It behoves the government to take pains to get the policy right before implementing it.

5.5 BVT is used successfully in other government services

Competitive tendering is widely and successfully used in government and in industry for procurement of products and services such as in health services support, road transport, construction, IT, consulting and many others.

Tendering is a central component of government procurement in the UK and EU, and is a legal requirement for large contracts. UK Public Procurement Regulations (following EU Directives) require public agencies to conduct an open and fair tendering process in all cases where that total value of the contract exceeds a specified threshold (currently around £150,000 for goods and services and £3,500,000 for works).⁸ It is a fundamental principle that government contracts should be let as the result of competitive tendering.⁹

The DTI Procurement Guide sets out recommendations for procedures to follow for different sized government procurement contracts.¹⁰ It states that the normal procedure is to let contracts by competitive tender, and recommends that all projects above £10,000 should use formal competitive tendering. The procurement guide states:

⁸ MSH (2005), "Legal Aspects of Procurement", 18 November 2005.

<http://www.campus.manchester.ac.uk/purchase/eu%20guide.htm>

⁹ <http://www.hse.gov.uk/sellingtohse/policy.htm#tender>

¹⁰ DTI (2006), "Procurement step by step: A short guide to buying", URN No: 03/1840
<http://www.dti.gov.uk/about/procurement/buyers-guides/page15431.html>

Choosing the Procurement Strategy

This is how you go about getting your supplier. Government policy is that the normal route by which contracts are let is by competitive tender. This is recognised as providing best value for money, which must be behind all decisions when it comes to awarding a contract. There are though exceptional circumstances, which may make single tender action permissible such as no alternative source continuing use of specialist services. You can find further details here.

In general terms the following are recommended limits for seeking either quotes, tenders or use of the Government Procurement Card

<£500	Use the Government Procurement Card (although higher levels may be used in some circumstances)
>£500, <£10,000	Seek at least three quotes
>£10,000	Undertake formal competitive tendering
>£100,410	Advertise in the European Journal and use the Restricted Procedure; Exceptionally – Single tender action

Tendering is also widely used in smaller public contracts. The DTI Small Business Services agency provides guides for small firms on how to use tendering for government contracts.¹¹

Tendering is part of best value procurement procedures followed by the UK Office of Government Commerce (OGC). The OGC works with public sector organisations to gain the best possible value for money from procurement, in sectors including local government, NHS, education, central government, defence, other public sector procurement. The OGC works in support of the Government's targets which includes the achievement of £8 billion savings per year through efficient public procurement.¹² The OGC includes OGCbuying.solutions, an executive Agency of OGC which provides a professional procurement service to central government and the wider public sector. This includes products and services organised into four categories: IT, telecoms, professional services, facilities.

Tendering tends to work best where the pool of qualified suppliers is not limited to current suppliers and also where this includes potential entry from firms able to shift from other related business to provide a cross-check on prices. Special procedures may be needed for government procurement where there are few contractors qualified to make quotes.

5.6 Contract duration

Over the long term there would be a series of contract cycles, in which firms compete for contracts to provide services for a given period, say three to five years. To ensure adequate competition over the long term, contracts should be set long enough for firms either to enter and obtain a return on their entry investment during the contract period, or to provide incentives for firms to perform well enough to have a good prospect of winning an extended period contract for the next period and recover their costs over the longer period. Means should also be found to ensure that sufficient number and capacity of firms are available to provide effective competition for the second round of contracts.

¹¹ Small Business Services (2004), Tendering for Government Contracts A Guide for Small Businesses". http://www.sbs.gov.uk/SBS_Gov_files/services/tender.pdf

¹² <http://www.ogc.gov.uk>