Incentivised Skills Funding
The Role of Payment by Results

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Incentivised Skills Funding: the role of payment-by-results

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Executive Summary

Introduction

In April 2013 the London Enterprise Panel (LEP) set out its approach to promoting jobs and growth in London. The key aim of this approach is to get more Londoners into work and to equip them with the skills they need to compete for London’s jobs. With this aim in mind, the LEP called on government to:

- Amend the current funding structures to further incentivise providers to respond to the needs of the economy or specific sectors to deliver job outcomes, sustainability, career progression and progression in learning.

- Revise funding in the capital to incentivise skills and employment providers to work with SME (including micro) businesses.

The Greater London Authority commissioned the Centre for Economic and Social Inclusion to support the LEP Employment and Skills Working Group to develop these two recommendations into workable proposals for implementation. This work involved a review of relevant literature and good practice, depth interviews with representatives of key organisations with an interest in this debate and a recommendations workshop to ‘stress test’ emerging options.

Current Funding Model and Delivery

Within all 19+ Adults Skills Budget provision payments are made to providers on the basis of enrolments. The total eligible funding per enrolment is then split; 80 per cent paid in monthly on-programme instalments whilst in learning and the remaining 20 per cent is paid on successful achievement of the qualification. In circumstances where eligible unemployed learners fail to achieve their enrolment owing to securing an eligible job, the Skills Funding Agency (SFA) will pay half the achievement funding as compensation. This compensatory funding is known as the ‘job outcome payment’.

This research has identified a number of perceived weaknesses in the current funding system, in terms of the way that it drives provider behaviour and the outcomes it generates. The job outcome payment only applies to eligible unemployed learners and is valued at just half the achievement instalment. The funding system contains no payment for positive outcomes beyond certification, such as progression or sustained employment. It is argued that these factors drive too many Further Education (FE) and skills providers to focus primarily on certification, with little interest in progression and or the employment prospects of learners.

When inspecting FE and skills providers, Ofsted is required to consider the destinations of learners on leaving their programmes and also evaluate how well providers tailor their
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provision to local labour markets and the needs of local communities. However, Ofsted’s ability to do this effectively is restricted by the fact that destinations data is not routinely, comprehensively and accurately collected and reported within FE. Some colleges have begun to invest in tracking job outcomes for unemployed learners but they find it difficult and resource intensive.

Whilst the funding model focuses providers’ attentions on course delivery and certification, it cannot sufficiently meet the London Enterprise Panel’s aim to get more Londoners into work and to equip them with the skills they need to compete for London’s jobs.

**Use of Payment by Results**

The current skills funding model has a minimal element of payment by results (PbR) in that providers are paid based on the achievement of learner outcomes. However there is clear appetite from policy makers for greater use of payment by results within skills funding, as a mechanism to focus providers’ attentions on local labour market demands.

PbR offers potential for innovation, flexibility and efficiency savings, and can act as a powerful tool for driving institutional and organisational change. However PbR also poses new challenges to policy makers who must design contracting systems that balance the incentive effect of outcome payments with the risk of larger providers squeezing out small and medium-sized providers and creating inducements for providers to ‘cream’ the more tractable cases and ‘park’ the less tractable ones.

These risks have been seen to materialise in PbR programmes operating in other countries and contexts. International practice offers potential mitigations to these risks, such as a range of outcome indicators and payment for intermediate outcomes, but these improvements often involve trade-offs including a reduction in flexibility or innovation. The LEP must take careful account of such trade-offs when considering designs for any future PbR programmes.

The funding model is just one mechanism through which the LEP can seek to ensure that local skills provision is tailored to local labour markets. The LEP has a vital role in influencing BIS, Ofsted and FE and skills providers to prioritise measurement of destinations and to make greater use of labour market intelligence about employer demand. The LEP should also seek to engage with FE and skills providers to discuss the need for reform and to champion existing efforts to help learners to enter, sustain and progress in work.

**Redefining the Current Funding Model**

Our proposal for immediate implementation is a redesign of the current PbR element to better reflect the LEP’s desired outcomes. The outcomes rewarded by skills funding would no longer be qualifications but wider outcomes such as job entry, sustained employment and progression into further learning. Whilst more work needs to be done to facilitate
measurement of in–work progression, this change would send a clear signal that the skills system is responsive both to the needs of the learner and to the local labour market. This is a signal that has so far been missing from strategic skills funding statements.

This change to the definition of positive outcomes from training must be supported by the collection of robust data against these outcomes. Government data on employment wages is currently not sufficiently accessible or real-time enough to support a funding model. The LEP has a role in continuing to lobby for that to change. In the interim, consistent destinations tracking will require innovation and investment of provider resources. There is already a move towards this with new Individualised Learner Record (ILR) ‘learner outcome and destination’ data fields being introduced by the SFA for the 2014/15 academic year. Some providers will be used to collecting this data for the SFA’s European Social Fund (ESF) ‘Skills Support for the Unemployed’ programmes, which includes a payment for job entry and in London, a payment for 26 weeks sustained employment. We expect that providers will see a return on their investment in destinations tracking as they will be able to market themselves to employers and learners based the outcomes they achieve.

Getting the balance right between a level of outcome funding that acts as financial stimulus to achieve positive outcomes but that does not risk reducing the quality of provision, is critical. We recommend that initially the 80:20 split is retained whilst the impact of altering the definition of positive outcomes (i.e. away from qualifications) is evaluated. We propose annual reviews of how the new approach is meeting the LEP’s aim of provision that is responsive to labour market need. Should the balance be judged to be ‘off’, i.e. behaviours are not changing and outcomes are not aligning with labour market need, the LEP may decide to recommend an adjustment to the funding model, in favour of greater outcome-based funding.

We propose that this approach be applied to all skills funding on a contract basis – for both unemployed and employed learners. Using this model only within provision for the unemployed would not drive the cultural change that is necessary to support a radical refocusing of provider priorities and behaviours. However we recognise there are important differences between unemployed and employed learners, therefore any new system needs to be carefully monitored for how results may vary between the two groups.

**Strengthening relationships with SMEs**

Increased delivery costs can act as a disincentive for providers to build relationships with Small and Medium Enterprises (SMEs) to upskill their employees. One of the key objectives for this project is to ensure that no Londoner or London business is left behind, therefore ways to strengthen relationships between SMEs and FE and skills providers must be considered.
We recommend the LEP trials an approach based on the current 19+ apprenticeship funding methodology within which providers are paid 25% less for delivering to large employers. The savings from this approach would then be used to fund ‘bonus payments’ to the SME. As government introduces mandatory fees for employers, SME’s would use their grant or bonus payment to offset the employer fee but the provider would still be paid the full fee. In this way relationships between providers and SMEs are incentivised but from the perspective of the employer, rather than the provider.

**Test, Learn, Adapt**

Our recommendations also acknowledge that there are many uncertainties around the use of payment by results. Designing a successful model requires trade-offs between a complex array of factors. We therefore recommend the London Enterprise Panel works with BIS and the SFA to develop a number of pilot projects to test different incentivisation models and variables within them. The obvious mechanism for this approach would be to use the new European Social Fund 2014-2020 programme. The key issues for testing and trialling are those that underpin the success or failure of a PbR system, such as, measurable outcomes, the ‘right’ balance of programme:outcome payments and how to protect the most vulnerable learners and providers.

**Summary of Recommendations**

Based on the findings of this project, the LEP is recommended to:

- Redefine positive outcomes from skills provision towards employment and progression and away from achievement of qualifications – for all types of learning;

- Require the completion of learner outcome and destinations fields in the ILR system for all learners – including those currently in employment;

- Consider how to support London’s FE and skills providers to track destinations of learners in a cost effective manner with minimal administrative burden;

- Collate and share the learning from FE and skills providers delivering SFA ESF ‘Skills Support for the Unemployed’ provision in terms of operating under PbR and destinations tracking;

- Continue to lobby government to provide timely access to central employment and earnings data at FE provider level;

- Conduct annual reviews of the impact of the above changes on the extent to which London’s skills provision is meeting LEP strategic objectives and assess the requirement for increases in outcome-based funding;
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- Design and procure a series of ESF-funded pilots to test and evaluate the key principles and processes which will underpin a successful PbR model for skills funding;

- Engage with London FE and skills providers to discuss and debate the need for reform and to also champion the contribution that providers are already making to help learners to enter, sustain and progress in work;

- Advocate for increased weight to be given in Ofsted inspection to indicators of labour market responsiveness such as: level and quality of employer engagement, use of labour market intelligence and quality of careers information, advice and guidance.
1 Introduction

The context

1.1 London is a leading global city and the engine of the UK economy. Prior to the recession job growth in London was unabated resulting in around 800,000 new and replacement jobs between 1996 and 2008.1 London now accounts for around 19 per cent of jobs, 21 per cent of businesses and 25 per cent of economic output in the UK. The London labour market has remained relatively buoyant given the underperformance of the economy in recent years. The UK’s tentative economic recovery has been one very much led by the capital.2 By 2020 the total number of job openings is expected to be more than 2.2 million.

1.2 But, like any city, London faces its own challenges. London’s employment rate is improving but at 72.5% remains slightly below the UK average of 73.1%, and has trailed the UK average for more than two decades.3 On the one hand, London is the most prosperous city region in the UK, accounting for more than one-fifth of national Gross Value Added. On the other hand, earnings have fallen, living standards have stagnated, and working poverty is increasing alongside job insecurity. In London you are more likely to be rich, but also more likely to be poor, than anywhere else in the country.4

1.3 In April 2013 the London Enterprise Panel (LEP) set out its approach to promoting jobs and growth in London. The Jobs and Growth Plan outlines four investment priorities for London, the first of which is skills and employment. The Plan sets out the intention for the LEP to use its strengthened role in economic development to continue to promote, champion and lead a strategic approach to employment and skills for London.5

1.4 The key aim of this approach is to get more Londoners into work and to equip them with the skills they need to compete for London’s jobs. With this aim in mind, the LEP made three overarching recommendations to Government. The first of these recommendations was that the GLA should become the Managing Authority for the 2014-20 European Structural Innovation Fund (ESIF). This would make the GLA, along with the LEP, directly responsible for ESF programme design and administration in the

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2 Centre for Cities (2014), Cities Outlook
3 Source: Labour Force Survey March –May 2014
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capital. This would be a significant step given that a previous report to the GLA concluded that “much of the more bespoke skills provision designed using European Social Fund money is poorly designed and performing below expectations.” Although the LEP is responsible for strategic allocation of ESIF spending, the GLA was not given Managing Authority status, although it has retained its Intermediate Body role.

1.5 The two remaining LEP recommendations are the focus of this project. The LEP called on the Government to:

- Amend the current funding structures to further incentivise providers to respond to the needs of the economy or specific sectors to deliver job outcomes, sustainability, career progression, and given the requirement for higher level skills over the next decade, progression in learning. The LEP does not seek to meddle in market forces by centrally planning which sectors may or may not be required, but has a strong belief that with the right funding incentives in place to reward providers for progression or job sustainability, the market will drive the requirements for skills and meet the needs of the economy; and

- Revise funding in the capital to incentivise skills and employment providers to work with SME (including micro) businesses. The current reality is that the funding awarded does not reflect the higher costs of delivery to SMEs with specific requirements. To ensure that no Londoner or London business is left behind, the LEP expects the government to create a tiered level of funding similar to the disadvantage uplift already available to colleges, and which builds upon the reduced funding awarded to large employers. The panel requires an ‘SME’ funding uplift which realistically reflects the higher costs of delivering to small businesses.

The project

1.6 The Centre for Economic and Social Inclusion (Inclusion) was commissioned by the GLA to support the LEP Employment and Skills Working Group to develop these two recommendations into workable proposals for implementation. The specification for this project placed a particular emphasis on the potential for ‘Payment by Results’ (PbR) models to provide; “the right funding incentives...to reward providers for progression or job sustainability”. The report is part funded by ESF Technical Assistance and its findings will help to inform the development of ESF and match

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6 There are five co-financing organisations in London responsible for matching funding and allocating ESF. In order of programme size, these are the Skills Funding Agency, the Department for Work and pensions, the National Offender Management Service, the Greater London Authority and the London Councils.

7 Krasnowski, K and Vaid, L (2012) Right Skills, Right Jobs, GLA
funded provision in the new 2014-20 programme. The work took place between May and June 2014 and comprised three stages.

1.7 The first stage was a **scoping review** to generate a high-level overview of the drivers in the existing funding system, the strengths and weaknesses of the current system, and the changed behaviours required and desired outcomes. We reviewed: best practice in incentivised funding systems and payment by results; learning from other pilots and policies; and the output from the 2013 London LEP/BIS/SFA workshop (which informed the commissioning of this project).

1.8 This was followed by **depth interviews**: in recognition of the level of thought and discussion that has already taken place in this field we interviewed eleven representatives of key organisations with an interest in this debate. The purpose of the interviews was to discuss the advantages and potential problems in the direction of travel, both the extent of support for and challenges of payment by results, and the design of future funding models. The organisations represented were:

- Association of Employment and Learning Providers (AELP)
- Association of Colleges (AOC)
- London Councils
- Skills Funding Agency (SFA)
- National Careers Service
- Department for Work and Pensions (DWP)
- Department for Business, Innovation and Skills (BIS).

1.9 These findings were brought together at a **consultation workshop** (intended as a follow up to the 2013 London LEP/BIS/SFA workshop) which involved a wider range of stakeholders than the interviews and was designed as an opportunity to ‘stress test’ emerging options. At the workshop representatives of the SFA, London Councils, BIS, AOC, AELP, the GLA and a number of London colleges were encouraged to question and challenge the proposals. Their feedback has been incorporated to this report through refinements to our recommendations.

**The report**

1.10 The first chapter of this report draws on the scoping work and interview data to set out the current model of funding and delivery, its perceived advantages and disadvantages and scope for reform. Chapter two also draws on the scoping review and interviews to explore the mechanisms that will enable the LEP to achieve the outcomes it requires for London, and discusses the ability of outcome-based funding to achieve them. Chapter three sets out Inclusion’s recommended overall approach to
reform of the skills funding system in London, before going into detail on specific elements of our proposal. The report closes with some conclusions on how PbR and the recommendations made here can contribute to the achievement of jobs and growth in London, as well as some of the broader factors that will facilitate this process.
2 Current Funding and Delivery Model

2.1 Currently skills funding in England is determined centrally. There are few devolved flexibilities in skills funding. The Skills Funding Agency (SFA) is an executive agency of the Department for Business Innovation and Skills (BIS) and is responsible for the distribution of Further Education (FE) and Skills funding in England.

2.2 The Greater London Authority Act of 1999 gave the Mayor the authority and powers over significant areas of London’s economic regeneration and infrastructure. However, the Act did not give the Mayor any clear skills and employment powers. Both the current Mayor and his predecessor have set out proposals for the devolution of employment and skills to the Mayoral level with limited success. Most recently, in 2010, The Mayor’s ‘Proposals for Devolution’ outlined plans for further devolution of the skills and employment system in London, and in particular argued for the Mayor to be given full powers over the allocation of a regional skills budget devolved from the Skills Funding Agency (SFA). Whilst the Mayor succeeded in obtaining a number of new devolved powers in the Localism Act 2011, additional skills and employment powers were not granted.¹⁸

2.3 Each year the SFA distributes approximately £3bn in course funding for around 3m learners through contracts with just over 1,000 colleges and other private and third sector training providers. Around £700m is spent each year delivering adult skills in London; with 50 colleges supporting 380,000 learners and hundreds of training providers supporting thousands more employers and learners.⁹ The SFA is also responsible for financial assurance of the public funds, as well as directing the funding to provision aligned to the priorities within the annual BIS Grant Letter.

2.4 In August 2013 the SFA introduced a new ‘streamlined’ national funding methodology for all 19+ Adults Skills Budget provision (see ‘A New Streamlined Funding System for Adult Skills’, March 2013, Skills Funding Agency). Each enrolment (typically qualification) has a cash rate listed on the SFA learning aims search facility, which increases within set size bands (typically the number of Qualification Credit Framework credits). The learning aim search facility also lists the rate after a programme weighting has been applied, based on the sector subject area. This is known as the ‘weighted rate’, which may then be increased further by a ‘disadvantage weighting’ of up to 32 per cent (based on the home postcode of the learner) as well as an ‘area cost weighting’ of up to 20 per cent for inner London (based on the

⁹ Ibid.
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delivery location). In addition, learners ineligible for full funding (such as 19+ apprentices) would only generate half the published funding rate.

2.5 The total eligible funding per enrolment is then split; 80 per cent paid in monthly on-programme instalments whilst in learning and the remaining 20 per cent is paid on successful achievement of the qualification (or equivalent non-certificated outcome). In circumstances where eligible unemployed learners fail to achieve their enrolment owing to securing an eligible job\textsuperscript{10}, the SFA will pay half the achievement funding as compensation. This compensatory funding is known as the ‘job outcome payment’. The job outcome payment recognises that training participation may have contributed to the job outcome and also mitigates some of the risk that providers seek to retain learners on a course to receive the qualification payment, thus preventing a positive employment outcome.\textsuperscript{11}

2.6 In this way it could be argued that skills providers are already partially paid on the basis of the results that they achieve, i.e. the qualification or a job outcome achieved. In addition many training providers receiving SFA funding will also be receiving ESF funding, co-financed by the SFA and/or other CFOs. The SFA’s Skills Support for the Unemployed (SSU) programmes already include a payment for job entry and sustained employment, which requires collection of destinations data for learners (via the ILR or other monitoring systems) for up to six months after programme completion. Therefore, although mainstream funding does not operate along the lines of PbR, many providers will be used to working in this way for at least some of their funding.

Advantages

2.7 When considering the scope for reform, it is important to recognise that we are not starting from a blank sheet of paper. Although that clean slate may seem desirable, there are also many positives of the current system which any new system should seek to replicate or build upon.

2.8 The current system applies a national formula and rates to a monthly Individualised Learner Record (ILR) data returns, making it transparent and avoiding any unintended inconsistencies across contracts or regions. If the course stops so does the monthly funding. The use of various weightings and of co-funding makes for a fairly complex calculation, but also one that can generate a ‘fair’ value across the full range of

\textsuperscript{10} Eligible jobs are usually of 16 hours per week and lasting a minimum of 4 weeks. See SFA Funding Rules for more detail.

\textsuperscript{11} There is a wider issue with the ability of learners to continue learning post work entry if they no longer qualify for fee remission.
provision, including for learners who are out of work, those in work and those with complex needs.

2.9 The majority of the public funding (80 per cent) is for the course delivery, which recognises that this is where much of the costs are found and that courses must run even when not full. The achievement funding (20 per cent) incentivises a successful conclusion to the course, which is usually easy to evidence with copies of certificates or awarding organisation data. Providers currently find other outcomes difficult to evidence; job entries (for example) can take time to materialise and, unlike Higher Education leavers, those completing FE courses can be difficult to maintain contact with. Until new ILR fields are introduced this type of data collection is not mandatory, but some colleges have begun to invest in tracking job outcomes for unemployed learners. Some colleges have undertaken destination tracking and found it incredibly time consuming, given London’s highly mobile population. For example, a London college spent 5 person days following up 80 students off a NEETs course and after 3 months had achieved a 75% ‘known rate’. For a typical college with 5,000 students the AoC estimates that this would require two or 3 full time posts at a cost of about £100k or £3m for London colleges.¹²

2.10 Ofsted inspection also increasingly acts as an important incentive for providers to consider progression into work, career progression and progression to further learning. The new Ofsted Common Inspection Framework currently requires inspectors to consider the destinations of learners on leaving their programmes and to evaluate how well providers tailor their provision to local labour markets and the needs of local communities.¹³ As a starting point for judging learners’ outcomes, inspectors will use the appropriate ‘all’ national success rates. To arrive at a final judgement they must also take into account a range of other factors. These include: socio-economic factors, prior attainment, high grades (where appropriate), size and volume of provision, local factors such as employment rates and success rates achieved by similar groups of learners (for example, by comparable provision type, age and by level of course) and trend data over time. Inspectors will also take into account provider-specific risk factors with provision such as that for young learners who have recently not been in education and training (NEET) or long-term unemployed adults.¹⁴

2.11 However, although destination measures are published by the DfE for learners aged 16-18 these only include those learners completing KS5 (level 3) and BIS statistics on adult learners due to be published this summer are experimental (see chapter 3).

¹⁴ Ofsted (2014) Guidance on the use of data to support judgements on ‘outcomes for learners’ in further education and skills inspections
Currently Ofsted relies on providers to fill in the gaps in the gaps, for example for younger learners completing level 2, by sharing any data they may or may not have collected which is patchy at best. This makes it very difficult for Ofsted to validate judgements on destinations or meeting local and national employer needs.

2.12 Although typically fairly general in their nature, Ofsted does make related statements in the ‘outcome for learners’ section of their inspection reports, such as this for one London college: “Internal rates of progression to higher levels of study for learners who remain at [this college] are high in many subject areas. Many learners from access courses, creative arts and health and social care, progress to higher education, although numbers are low in construction, engineering and ICT. Learners in sport, catering and floristry progress particularly well to employment. Rates of progression to apprenticeships and employment in engineering are low.” Such statements from Ofsted provide useful insights but could be strengthened with more quantitative data, which in turn would enable them to be given greater weight in the overall assessment.

2.13 Finally, the current payment model also allows some stability and guarantees in terms of provider finances as they know that unless a learner achieves neither a qualification nor a job they will receive the full funding allocation. FE and skills providers argue that this financial stability gives them the space to focus on quality and learner experience. However the counter argument is that the current payment model generates insufficient incentives for FE and skills providers to tailor courses to employer demand and/or to innovate.

Disadvantages

2.14 The majority of stakeholders interviewed for this project recognised that the current skills funding system could do more to support LEP objectives around sustained job outcomes and career progression. The interviews and evidence review identified a number of perceived weaknesses in the current system, in terms of the way that it drives provider behaviour and the outcomes it generates.

2.15 The ‘signals’ within the current funding system were the primary issue identified by this project. The job outcome payment only applies to eligible unemployed learners and is valued at just half the achievement instalment. The funding system contains no payment for positive outcomes beyond certification (i.e. achievement of qualification or other relevant course aim), such as progression or sustained employment. It is argued by some, that these signals drive too many FE and skills providers to focus primarily on certification, with little interest in progression and or the employment prospects of learners. This is critical for the LEP as, if true, whilst funding focuses providers’ attentions on course delivery and certification, it cannot sufficiently meet the Panel’s wider objectives around skills for productivity and growth.
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2.16 This argument is supported by research which suggests that UK skills policy has not always met the needs of employers. Evidence has shown failures in skills supply, demand and mismatch may be creating a disconnect between the skills we are producing and the skills our economy needs.\textsuperscript{15} Analysis of the match between FE achievements and job vacancies in aligned occupations in England suggested a failure by colleges and learners to identify occupations with relatively high demand but low supply and, in low demand sectors, too much demand from learners for these skills and/or supply from the FE sector.\textsuperscript{16} In December 2013 Her Majesty’s Chief Inspector said “only three of the 17 General Further Education colleges visited for the [national] survey had revised their curriculum content and structure considerably to focus on preparing learners better for opportunities in local employment and enterprise and to fill local, regional or national skills gaps that had been identified.” This is a direct contradiction of the London Enterprise Panel’s vision for skill provision in the capital and it has been recognised by the AoC: "We agree with much of the analysis of the challenge that faces the capital to get more Londoners into jobs, such as basic skills needs, health problems and the need to get a closer match between skills demand and skills supply."\textsuperscript{17}

2.17 However, we also have to recognise that some courses serve an important purpose of engaging students who otherwise might not participate in learning. In these cases, ‘engagement’ may be more important than direct relevance to the local labour market.

2.18 In addition employers continue to report some difficulties with employability skills and transferable skills.\textsuperscript{18} The recent House of Lords European Union Committee enquiry into youth unemployment cites repeated evidence from employers large and small of poor employability amongst applicants, and steps they themselves have felt obliged to take to overcome deficiencies amongst young people emerging from the education and skills system.\textsuperscript{19} The Federation of Small Businesses has recently highlighted skills shortages as a significant barrier to growth for small firms.\textsuperscript{20} In a survey almost one third (29.9%) of SME’s reported skills shortages as hampering growth.

2.19 Whilst some FE and skills providers assert that provision is meeting local labour market demand it is often difficult to find the evidence to support this as destinations from FE are not sufficiently and systematically recorded. As Ofsted puts it, there is; “still no clear measure of the true impact of provision on meeting local needs”. Where jobs are measured for college performance purposes only around 10 per cent of

\textsuperscript{15} UKCES (2010) Ambition 2020
\textsuperscript{16} Gardiner, L and Wilson, T (2012) Hidden Talents: Skills Match Analysis, LGA
\textsuperscript{17} AoC (2013) Ibid
\textsuperscript{18} UKCES (2014) Employer Skills Survey 2013: Survey Results
\textsuperscript{19} House of Lords European Union Committee (April 2014) Youth Unemployment in the EU: a scarred generation?
\textsuperscript{20} Small Business Index Q2 2014, Federation of Small Business, 2014
people are in work following course completion.\textsuperscript{21} Again the AoC is in agreement; “\textit{We agree that improving information available to employers, learners and providers is key and that colleges have a key role to play in inputting into this data.}”\textsuperscript{22} However as long as BIS funds providers to achieve learning outcomes and does not require the measurement of other destinations, concerns will continue to be raised about the responsiveness of FE provision to the labour markets that it serves.

\textbf{2.20} Commentators and interviewees within this project have suggested a need to adjust the outcomes that are funded by the SFA in order to re-orientate FE provision. Ofsted’s 2013 annual report stated that; “for learners, outcomes mean more than the achievement of a qualification. Provision should lead on to further or higher education, training or employment”.\textsuperscript{23} Similarly the UK Commission for Employment and Skills (UKCES) has suggested that skills outcome measures could include ‘progression in learning or work, wage gain, learning achievement, customer satisfaction and quality’.

\textbf{2.21} Refocusing outcomes in this way could also help to better align the priorities of skills providers with the outcomes (increasingly) prioritised by the providers of employment support. In 2006 the Leitch Review set out the conditions required for a ‘World Class Skills’ system – key to which was the better integration of disjointed employment and skills systems. Leitch noted that welfare to work programmes had few incentives to focus on skills, job retention and progression; the skills system had little focus on employment outcomes; and the targets and incentives in both systems did not encourage a joined-up service for individuals or employers.\textsuperscript{24} A 2010 UKCES review of lessons from contracting out employment and skills internationally identified that efforts to improve the connections and coordination between these ‘work first’ and skills development programmes are hampered by the distinct funding streams and bureaucratic mechanisms through which such outcomes are sought.\textsuperscript{25}

\textbf{2.22} A drive for greater focus on career progression in skills funding comes at the same time as discussions about the re-design of the government’s main form of provision for the unemployed, the Work Programme, and the need for such programmes to fund on in-work progression as well as sustained jobs.\textsuperscript{26} A more aligned framework of

\begin{footnotesize}
\textsuperscript{21} Krasnowski and Vaid (2012), Ibid. Please note this data is very limited.
\textsuperscript{22} AoC (2013) Ibid.
\textsuperscript{23} Ofsted (2013) \textit{The report of Her Majesty’s Chief Inspector of Education, Children’s Services and Skills: Further education and skills}
\textsuperscript{24} HM Treasury (2006) \textit{Leitch Review of Skills: Prosperity for all in the global economy – world class skills}
\textsuperscript{25} Finn, D (2010) \textit{Outcome Based Commissioning: Lessons from contracting out employment and skills programmes in Australia and the USA}, UKCES
\textsuperscript{26} This is related to the introduction of Universal Credit within which, in-work conditionality requirements will encourage claimants to increase their hours and earnings.
\end{footnotesize}
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outcomes could go a long way in creating greater integration between the two systems.

Conclusions

2.23 This chapter has helped to shape recommendations for the future of skills funding models by identifying the positive factors that should be retained, as well as the key challenges that must be addressed.

2.24 Any future system should seek to be consistent enough to avoid any unintended inconsistencies across contracts or regions, although there may be scope for greater responsiveness to local need. Provider funding should recognise the costs of programme delivery and be sufficiently stable to facilitate investment in service quality. There is value in a single management and reporting system, such as the ILR, which enables payments to respond to real-time data returns. Provision quality and achievement of work-related outcomes should continue to be closely monitored by Ofsted.

2.25 There is currently insufficient evidence that FE outcomes are responding to the needs of local employment and enterprise, to fill local, regional or national skills gaps. Whilst funding is seen to focus providers’ attentions on course delivery and certification, it cannot sufficiently meet the wider objectives that the London Enterprise Panel aims to achieve. It has been suggested that incentivising providers to focus on outcomes other than certification through the funding model, would better align the objectives of the FE sector, the employment sector and those interested in economic growth. More systematic measurement of destinations data would also enable FE and skills providers to better evidence their contribution to the local labour market.

2.26 There is a minimal amount of outcome-based funding already present in the current SFA system and those providers involved in ESF Skills for the Unemployed provision will be well accustomed to this way of working. There will be lessons that can be learned from their experiences in terms of building the capacity to operate within a PbR model and how they track and record learner outcomes.
3 Drivers of Provider Behaviour

3.1 In relation to employment and skills, the strategic objective of the London Enterprise Panel (LEP) is to respond to the needs of the local economy to deliver job outcomes, sustainability, career progression and progression in learning. To achieve this objective the LEP needs to clearly understand how best to influence government and employment and skills providers to design and deliver funding that will generate these outcomes.

3.2 Funding is one way that the LEP can influence providers and there is an increasing belief, amongst politicians and policymakers that, through attaching funding to desired outcomes, the market will drive providers to achieve commissioners’ strategic objectives. This principle is evident in recent skills strategy publications:

“*We will explore the scope for defining robust outcomes from learning which could replace qualification achievement. This will involve substantial work: establishing the right set of measures; looking at different models of payment by results; and finding the right place for such a mechanism within the wider system.*”

“*We will support the rigour and work focus of training for the unemployed, by strengthening quality incentives for training providers to achieve employment outcomes; and by exploring how we can reward providers financially for the employment outcomes they achieve. This will encourage greater joint working between training providers and employers.*”

Outcome based commissioning is part of the systemic change needed to improve the efficiency and effectiveness of British employment and skills provision... full transition to such a system should be part of a dramatic simplification of commissioning and contracting arrangements where providers’ success is ‘defined and measured’ in terms of their responsiveness to labour market needs and the outcomes from their provision.”

3.3 Strategic impetus from government on payment by results will be important in creating buy-in and driving behaviour change at local levels, and amongst providers. However, PbR rhetoric has been supported by limited practical application to date.

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27 BIS (2014) *Getting the Job Done: The Government’s Reform Plan for Vocational Qualifications*

28 BIS and DfE (2013) *Rigour and Responsiveness in Skills*

3.4 In the 2011 ‘New Challenges, New Chances’ FE reform plan BIS announced that it would be piloting Job Outcome Incentive payments in the adult skills budget.\(^{30}\) In 2012, this was scrapped in favour of the ‘job outcome payment’ model discussed in the previous chapter. The 2012-2015 Funding Statement, BIS stated that; “this year, we will support City Region partners, who are interested in piloting further incentives for providers, to deliver job outcomes for unemployed learners as part of their City Deals”.\(^{31}\) Little progress has been reported to date.

3.5 In late 2013 the Secretary of State for Business, Innovation and Skills announced three pilots which are due to commence in the 2014/15 academic year, in the West of England, North East, and Stoke and Staffordshire LEP areas. Their aim is to link skills funding to local skills needs as identified by Local Enterprise Partnerships (LEPs). However normal funding rules will apply.

3.6 Earlier in 2014 the Departments for Education (DfE) and Business and Innovation and Skills (BIS) published a joint consultation, specifically to consider how Traineeships, their new flagship youth employment scheme, might in future be funded to "have a greater focus on positive outcomes." The consultation invites comments on four example funding models which involve various combinations of ‘engagement’, ‘milestone’, ‘on programme’ and ‘sustainable outcome’ payments.\(^{32}\) The response to this consultation is expected to be published in late 2014, ready for implementation in the 2015/16 academic year.

3.7 London’s European Social Fund programmes could be considered ahead of the curve, given that the Skills Funding Agency’s ESF Skills Support for the Unemployed programmes already include a payment for job entry and sustained employment. The GLA has commissioned a study on lessons learned from the 2007-2013 ESF programme which is due for publication in autumn 2014. In terms of provision for people in-work, the SFA is also funding an ESF Work Place Learning contract (2012 to 2015) which is piloting in-work progression as a paid outcome.

Payment by Results

3.8 Outcome-based funding encourages providers to focus on ends, not means, and is often seen as a way of promoting improvements in service delivery. Payment by results aligns funding arrangements with this outcomes focus by paying for services, at least in part, on the basis of the outcomes that they achieve. The attractiveness of this approach for the commissioner is that some of the ‘risk’ of funding provision

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\(^{30}\) BIS (2011) *New Challenges, New Chances: Next Steps in Implementing the Further Education Reform Programme*

\(^{31}\) BIS (2012) *Skills Funding Statement 2012-15*

\(^{32}\) DfE and BIS (2014) *Traineeships Funding in England*
(which may or may not lead to an outcome) is transferred from commissioner to provider. 33

3.9 The transition to outcome based employment and skills procurement offers potential for innovation, flexibility and efficiency savings, and can act as a powerful tool for driving institutional and organisational change. In Australia, contracting out of employment services has driven down costs. In 1995-6, the cost per employment outcome was around A$16,000; these costs had fallen to around A$3,500 by 2005, as the real value of fees and outcome payments fell after 2003. In the UK, the Work Programme has reduced costs of support, when compared to other programmes such as the New Deal and Future Jobs Fund. Work Programme payments per person are currently running at 14% lower than was originally planned.

3.10 Learning from DWP outcome-based commissioning identifies some key principles of effective PbR. These are:

- The proportion of the total contract value tied to results must be high enough to ensure that providers cannot survive on service fees alone, with outcome-based payments providing a top-up. In the early rounds of contracting under the Australian Job Network, for example, providers were deriving 70% of their income from high commencement fees. Changes to the Australian system, which shifted the performance emphasis to full-time employment outcomes, saw a significant increase in the achievement of job outcomes over time.

- The trigger for payments should be as close as possible to the eventual desired outcome. In earlier PbR employment programmes, payments were based on simply entering a job. In the Work Programme by contrast, the maximum payment in respect of any participant among the harder to help groups is based on them remaining in work for two years.

- Effort should be made to reduce the scope for paying for deadweight outcomes. Deadweight refers to outcomes which would have occurred anyway, without the given intervention, and which therefore represent a waste of government funding. In the context of Further Education and Skills, deadweight occurs as a result of individuals or employers no longer privately financing their own skills acquisition, or those of their workforce, and substituting publicly financed training in its place. 34

33 Battye, F and Daly, M (2012) ‘Payment by Results in public service reform: silver bullet, dangerous weapon, neither, both?’, University of Sheffield paper
34 BIS (2012) Assessing the Deadweight Loss Associated with Public Investment in Further Education and Skills
3.11 However PbR also poses new challenges to policy makers who must design contracting systems that balance the incentive effect of outcome payments with the entitlement of service users to equitable treatment.\(^{35}\) The following section sets out some of the risks associated with PbR regimes as well as some mitigations that have been tested in other countries and contexts.

**Creaming and Parking**

3.12 ‘Payment by Results’ has become something of a controversial topic and has often been associated with larger providers squeezing out small and medium-sized providers and creating inducements for providers to ‘cream’ the more tractable cases and ‘park’ the less tractable ones. The generally accepted definition of ‘park’ is that a participant (or learner) receives a reduced service (and expenditure) because of the increased risk to the provider of not securing an outcome payment. There is evidence that minimising cream-skimming, creaming and parking are significant challenges in both public and private sector incentive and target driven delivery systems.\(^{36}\)

3.13 Stakeholders consulted in this research were very concerned with the potential for PbR to create a disincentive for providers to engage with learners from whom they may struggle to achieve a job outcome, leading to disadvantaged learners receiving a poorer quality service whilst they focus efforts on more job ready learners. A related risk, and one which is particularly present within the skills system where programmes are voluntary, is that of providers ‘cherry picking’ more advanced learners for participation. Stakeholders also identified a risk that PbR in skills funding would result in parking at course level whereby those courses that are less likely to generate outcomes, such as basic skills and ESOL, would be scaled back in favour of more directly work-focused provision (for example).

3.14 However such risks may be reduced through contract design and oversight. The DWP Work Programme introduced a ‘differential payment model’, where providers are paid at different rates for outcomes achieved by different claimant groups, with outcomes for the harder-to-help groups being paid at higher rates than those for groups closer to the labour market. This is similar to the ‘cost weighting’ approach used in skills to reflect the higher costs of engagement with and lower incentives to engage with disadvantaged learners. Work Programme evaluation suggests that the differential payment model is not driving provider behaviour as intended, with outcomes for the harder to help groups on disability benefits running significantly below minimum

\(^{35}\) Finn, D (2010) *Ibid*

\(^{36}\) House of Commons Library (2013) *Briefing Note: Delivering public services: The growing use of Payment by Results*
expected standards. However, this may not result from the model itself but rather the level at which differential payments have been set (in terms of their ability to sufficiently compensate for the risks of delivery) and the level of complexity in the payment model.

3.15 Stakeholders in this research were also very concerned about the use of job outcomes in skills funding in terms of the potential for providers to achieve positive outcomes by placing learners into low quality, low income roles which would be of limited benefit to the learner and the economy more generally. In other countries the inclusion of measures related to job retention, wages and benefits, and earnings gains, for example, help to diminish any incentive to place participants into poor quality jobs.

**Case study - Varied performance measures.**

Under the 1998 Workforce Investment Act (WIA) in the USA, the Department of Labour established performance measures that not only focused on job entries and retention, but also on earnings change. Providers working with young people faced different performance indicators, with greater emphasis placed on training and qualifications. The newly passed Workforce Innovation and Opportunity Act builds on WIA to create a single set of common measures for adults across all core programs, including both occupational training and adult education programs, and a similar set of common measures across all youth serving programs. Adult measures include: unsubsidised employment; median earnings; receipt of a secondary diploma or recognised postsecondary credential; measurable skills gains toward a credential or employment; and employer engagement.

3.16 Measures indicating completion of assessments and activities and regular surveys of participant and employer experience can also help limit the ability of providers to service clients differently. However, the challenge is to design such process and outcome measures in ways that do not create unnecessary administrative burdens and allow providers flexibility in how they secure outcomes.

**Case study - DWP Troubled Families Programme**

Prime providers are paid on the achievement of ‘progress measures’ and job outcomes on a 70:30 split. Providers put forward progress measures for which they would claim payment during the tender process; these were later refined in discussions with the department. A provider can claim payment from the Department where a participant

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Incentivised Skills Funding: the role of payment-by-results

achieves at least three progress measures after a 26 week period subsequent to attachment. Final outcome payments are made where an individual has been in employment and off-benefits for either 13 or 26 weeks out of 30 (depending on what benefit they claimed i.e. 13 weeks for those with disabilities).

We will learn from the forthcoming evaluation how effective this payment model has been, however it is already clear that Prime providers were able to come up with a diverse and innovative range of progress measures derived from their different delivery models.

3.17 Refinements to a PbR model in skills funding would inevitably result in trade-offs between the ability to protect vulnerable learners (and courses) and increased cost, administrative burden, a reduction in flexibility or innovation. Some residual creaming and parking risk is also likely to remain.

Case Study: Star Rating System

Australian Jobseekers are able to choose their provider but evidence found few felt equipped to do so due to limited information. The government introduced comparative ‘star ratings’ from 1999. The original aim was to inform participant choice, but the ‘stars’ were used also to drive provider performance.

The Department estimated that within two years of introducing reliable star ratings 13-week job outcomes increased from 15 per cent to 35 per cent. Providers had easy access to data enabling them to compare local performance and the Department would reallocate local market share at six-monthly performance reviews when star ratings were published. Increasingly contracts are simply ‘rolled over’ to existing contractors with good delivery ratings and outcomes. This reduces transaction costs but also limits scope for market entry and provider diversity.

Transfer of Risk

3.18 Linking payments to outcomes transfers delivery risk to providers. This can often be too risky a strategy for some providers, especially for medium to small-scale providers who will be unable to cover potential losses. Linking payments to outcomes may also lead to fluctuating revenue stream as there is often a delay between the time of outcomes assessment and the actual delivery of services. This can lead to working capital constraints for providers. Such constraints can both affect the quality of

40 Finn, D (2010) Ibid.
41 Bredgaard, T and Larsen, F (2006) Quasi-markets in employment policy in Australia, the Netherlands and Denmark
42 Cabinet Office website (April 2013) ‘Payment by Results and Social Impact Bonds’
service delivery, with providers less willing to invest heavily delivery where returns are uncertain, and the users targeted for that delivery, with priority given to those from whom providers are most likely to derive outcome payments (see creaming and parking section above).

### 3.19 Recent DWP programmes which have made use of PbR such as the Work Programme and the specialist disability programme, Work Choice, have seen prime providers offering modified payment models which transfer more/less of the financial risk on to their subcontractors, depending on the subcontractors’ ability to meet upfront delivery costs. Learning from this approach could be beneficial to commissioners seeking to ensure diversity is retained within the provider market.

### 3.20 One interviewee suggested that the use of social impact bonds could help to mitigate the financial risks to smaller providers. Social Impact Bonds (SIBs) are a subset of Payment by Results contracts which allows private investment to be used to pay for interventions, which are delivered by service providers with a proven track record.

**Case study – Think Forward, East London**

Impetus - the Private Equity Foundation partnered with Tomorrow’s People to launch ‘ThinkForward’. This programme provides tailored and intensive support to young people aged 14-19 in East London who are at risk of falling out of education, employment or training (becoming ‘NEET’). Social investors take all of the financial risk, and if it is successful the Department for Work and Pensions (DWP) will pay back their investment with a small return. Educational outcomes are measured throughout the five-year programme (attainment, behaviour and attendance) with the goal of preventing at least 80 per cent of participants from becoming NEET. The target for 2013 was for over 30 per cent of this group to attain five A*-C GCSEs and 55 per cent of the group achieved this goal - 83 per cent higher than the target.

**Alternative drivers**

### 3.21 Given the complexities of PbR, it is important to recognise that the funding model is not the only, nor necessarily the most effective, driver of provider behaviour. Interviewees for this project echoed the wider evidence when they emphasised that; "payment by results is a means to an end, not an end in itself”.

### 3.22 There are a number of ways in which the LEP might influence providers to deliver locally responsive provision which delivers job outcomes, sustainability, career progression and progression in learning:

- The positive role of Ofsted inspection has already been discussed and will continue to be key in both scrutinising provider performance and acting as a
driver to focus on outcomes beyond qualifications. Ofsted inspectors are required to consider the destinations of learners on leaving their programmes and also evaluate how well providers tailor their provision to local labour markets and the needs of local communities. However, the scarcity of data on learner destinations hampers their ability to make such systematic, data-verified judgements in this area. Ofsted inspection timeframes mean that even poorer performing colleges will only be reassessed every 12-24 months therefore whilst greater emphasis from Ofsted on outcomes would be welcomed; it can only be part of the answer to influencing provider behavior.

- The role of **employer demand** for skills features heavily in the current debate. Although stimulating employer demand for skills is slightly broader than the scope of this project, it is relevant in relation to this project’s objective to incentivise provision of training to Small and Medium Enterprises (SMEs). By stimulating employer demand for training, the theory is this then should have an impact on provider behaviour, so long as this demand is apparent to providers.

- Increasing stress is being placed on **Labour Market Information and Intelligence (LMI)** as a means for providers to understand the nature of the local economy and employer demand (past and future). There is an important distinction between ‘information’ and ‘intelligence’. On the whole there is sufficient information but the interpretation of this to inform provider decisions is often more difficult. Increasing the use of LMI by London providers should be a top priority and the LEP should review how it can best promote this. One interesting suggestion is to make FE and skills providers’ use of LMI and their analysis of employer demand a core part of Ofsted assessments of Careers, Information, Advice and Guidance (CIAG) functions. An extension of this idea is that without a good or outstanding CIAG function an FE provider is not able to achieve an overall rating at that level.

- The relationship between **local government** and education and training providers is also critical in that it is through FE and skills that local government seeks to achieve many of its objectives around local economic growth, regeneration, social cohesion and community well-being. In return, local authorities offer strong links with local employers and can act as a hub for local LMI for providers to draw on. Strengthening the relationship between individual local authorities, the LEP and the FE sector can help to create the conditions for responsive FE and skills provision that meets the local needs and fosters growth.

- Creating a change in **provider culture** is also vital. There are many skills providers who are committed to improving the employability of their learners and the importance of maximising the number of learners leaving to a job. However, as Ofsted has pointed out, this is by no means universally accepted. The LEP can
therefore have an ambassadorial role in winning the hearts and minds of London’s skills infrastructure.

- In the past, commissioners have aimed to ensure the achievement of desired results by being prescriptive about the form and content of service delivery. However the LEP has stated that is does not seek to meddle in market forces by centrally planning which sectors may or may not be required, but has a strong belief that with the right funding incentives in place to reward providers for progression or job sustainability, the market will drive the requirements for skills and meet the needs of the economy. However, service prescription is a strong driver of contractor behaviour and the LEP may need to consider where this is appropriately used, for example, to protect provision for vulnerable learners or send a strong signal on priority sectors.

Conclusions

3.23 This chapter has identified the appetite from policy makers for greater use of payment by results within skills funding, as a mechanism to focus providers’ attentions on the local labour market demands. This is part of a broader policy shift towards outcome-based commissioning in public services on the grounds of its potential to drive innovation, flexibility and efficiency savings. However, in spite of this growing interest, there has been relatively little evidence of PbR in practice within the skills field.

3.24 One advantage of this slower pace of change is that lessons can be learned from PbR implementation in other areas of public policy, in particular employment support. Some of the key concerns about PbR, in terms of the incentives it creates for providers to ‘cream’ the more tractable cases and ‘park’ the less tractable ones and the capacity of smaller providers to bear the transfer of financial risk, have materialised in the employment arena. International practice offers potential solutions, such as a range of outcome indicators and payment for intermediate outcomes, but these improvements often involve trade-offs including a reduction in flexibility or innovation. The LEP must take careful account of such trade-offs when considering the design of any future PbR programmes.

3.25 It is also important to recognise that the funding model is just one mechanism through which the LEP can seek to ensure that local skills provision is tailored to local labour markets. The LEP has a vital role in influencing BIS, Ofsted and FE and skills providers to prioritise measurement of destinations (either by provider collection or through access to government data on employment and wages) and to make greater use of labour market intelligence about employer demand. The LEP should also seek to engage with FE and skills providers to discuss and debate the need for reform.
Where provision is genuinely responsive, the LEP can also champion the contribution that providers are making to help learners to enter, sustain and progress in work.
4 Recommendations

4.1 This chapter sets out the project team’s recommended approach to reform of the skills funding system that, we believe, would incentivise delivery in line with the LEP’s strategic objectives. The recommendations cover both changes that could be implemented with immediate effect and those which may require a longer timeframe.

Overall approach

4.2 The current funding model has a PbR element to it but, as discussed, the outcomes it drives are not those believed to be the best for learners and their (potential) employers. Therefore our proposal for immediate implementation is a redesign of the current PbR element to better reflect the desired outcomes i.e. progression into and on in work and/or further learning.

4.3 The outcomes rewarded by funding will no longer be qualifications but wider outcomes such as job entry, sustained employment (26 week job outcomes are already measured in London ESF contracts) and progression into further learning. Whilst more work needs to be done to facilitate measurement of in–work progression, this change would send a clear signal that the skills system is responsive both to the needs of the learner and to the local labour market. This is a signal that has so far been missing from strategic skills funding statements.

4.4 This change to the definition of positive outcomes from training must be supported by the collection of robust data against these outcomes. As discussed in chapter two, measurement of FE learner destinations is patchy and more needs to be done. Government data on employment and wages is currently not sufficiently accessible or real-time enough to support an outcome based funding model. There are clear indications that better access to such data is forthcoming:

- DWP has recently announced that it will publish monthly, automated on and off benefit scans by employment provider, for participants of its Work Programme.43

- The forthcoming Small Business, Enterprise and Employment Bill will improve the provision of information about the destinations of 16 to 18-year-old FE learners by linking this to other national data, including that held by HMRC.44

43 DWP (2014) Work Programme guidance: on and off benefit scans
44 See FE Week 27th June 2014 'HMRC to give out learner details'
Experimental data is about to be released by the Department for Business, Innovation and Skills setting out destinations of adult FE learners for each individual SFA funded provider.

4.5 The LEP has a role to play in influencing to lobby government to facilitate access to regular and robust outcomes data for each FE and skills provider, at the earliest possible opportunity.

4.6 In the interim, consistent destinations tracking will require innovation and investment of provider resources. However providers will see return on that investment in terms of their ability to market themselves to employers and learners based the outcomes they achieve. Destinations tracking will also enable providers to genuinely demonstrate the important contribution that FE makes to economic growth.

4.7 As discussed in chapter three, one of the key principles of successful outcome based funding is that the proportion of funding allocated to outcomes must incentivise the achievement of those outcomes. Getting the balance right between a level of outcome funding that acts as financial stimulus to achieve those outcomes but that that does not risk reducing the quality of provision, is critical. At this point we have no reason to suspect that 80:20 is not the right balance but nor do we have the evidence to support that. For this reason we recommend that initially the 80:20 split is retained whilst the impact of altering the definition of positive outcomes (i.e. away from qualifications) is evaluated.

4.8 The LEP may find that recommending a change to the definition of positive outcomes and the introduction of more systematic destinations data collection has a significant impact on FE and skills providers’ responsiveness to labour market need. This would indicate that increasing the proportion of funding paid for outcomes is not necessary. However we recommend that this is something that the LEP keeps under review. We propose annual review of the ratio of the new funding model against the LEP’s strategic objectives. Should the balance be judged to be ‘off’, i.e. behaviours are not changing and outcomes are not aligning with labour market need, the LEP may decide to recommend an adjustment to the funding model in favour of greater outcome-based funding.

4.9 We have also suggested that the 20% of outcome based funding be split between payment on the basis of individual learner outcomes and on a contract basis against the proportion of positive outcomes achieved by a cohort of learners. The contract target could be set nationally and used as a performance management tool.

4.10 The diagram below gives an example of how the 80:20 split might look and how it might change over time, should it be deemed necessary to achieve the LEP’s strategic objectives.
4.11 We propose that this approach be applied to all skills funding on a contract basis – for both unemployed and employed learners. Using this model only within provision for the unemployed would not drive the cultural change that is necessary to support a radical refocusing of provider priorities and behaviours. However we do recognise there are important differences between unemployed and employed learners, therefore any new system needs to be carefully monitored for how results may vary between the two groups.

4.12 Our recommendations also acknowledge that there are many uncertainties around incentivising skills funding and in particular the use of payment by results. No ‘off the shelf’ model exists which could simply be introduced with predictable and reliable results. Instead there is a complex range of factors which the evidence suggests may be deliberately modified so as to deliver more desirable outcomes, but may also lead to unexpected or negative results.

4.13 We therefore recommend the London Enterprise Panel officers work with BIS and the SFA to develop a number of pilot projects to test different incentivisation models and variables within them. This may be as part of the London Growth Deal. In our view this would enable London to refine its own approach to these issues, using increasingly scarce resources to deliver better and more efficient outcomes. The

\[\text{Diagram: Programme funding vs Outcome funding vs ESF 2014-20} \]

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45 Cabinet Office and Deputy Prime Minister’s Office (2014) London: Growth Deal 2014
obvious mechanism for this approach would be to use the European Social Fund element of the 2014-2020 European Structural Investment Fund programme.

**Refining the current model**

**Redefining target outcomes**

4.14 Our recommendation is that from August 2014 the London Enterprise Partnership should trial the funding of FE and Skills contracts on the basis of 80 per cent for monthly course delivery (unchanged from the current system) and 20 per cent on a positive learner progression or destination (as opposed to the current payment for achievement).

4.15 This would have the advantage of retaining many of the benefits of the existing SFA funding system, whilst shifting the focus from paying for certification to paying for wider outcomes, such as progression and employment. It is also in line with the new funding methodology introduced by the EFA from August 2013 which included the removal of any funding associated with the achievement of the qualification.\(^{46}\) Although officially the EFA said it was to remove any confusion with success rates and simplify the funding formula, it is well known that there was concern that achievement funding was putting too much incentive on passing a qualification, rather than it being the appropriate qualification for the learner to successfully progress.

4.16 The 20 per cent positive learner progression could be split (such as 50:50) between a learner payment, and on the achievement of a contract performance target. This would have the advantage of putting a value on each individual positive outcome, whilst at the same time setting a stretching target for the contractor to be judged on and reward for achieving. The contract target could be negotiated through the tendering process based on historical performance (where known) or adjusted after a few years based on actual performance.

4.17 This proposal would require the contractor to collect additional outcome data, but the SFA have anyway introduced ‘learner outcome and destination’ fields for the 2014/15 academic year. However, in order to include progression as a positive outcome, we propose that contractor should be required to collect this data for all learners, not just those that are unemployed.

4.18 In the first year it is proposed that all outcomes within the new ILR fields, with the exception of ‘unemployed’ and ‘not known’ should be considered positive. This is not about rewarding providers purely for job outcomes. It also recognises the vital role

\(^{46}\) Education Funding Agency (2014) *Funding education for 14-19 year olds*
that training plays in helping people to develop a broad range of skills that may well help them to move into work eventually if not immediately, including through undertaking further learning. The ILR fields are shown in the table below. Positive outcomes are highlighted in yellow.

<table>
<thead>
<tr>
<th>Type</th>
<th>Code</th>
<th>Code Description</th>
<th>Valid to</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMP</td>
<td>1</td>
<td>In paid employment for 16 hours or more per week</td>
<td></td>
</tr>
<tr>
<td>EMP</td>
<td>2</td>
<td>In paid employment for less than 16 hours per week</td>
<td></td>
</tr>
<tr>
<td>EMP</td>
<td>3</td>
<td>Self employed</td>
<td></td>
</tr>
<tr>
<td>NPE</td>
<td>1</td>
<td>Not in paid employment, looking for work and available to start work</td>
<td></td>
</tr>
<tr>
<td>NPE</td>
<td>2</td>
<td>Not in paid employment, not looking for work and/or not available to start work (including retired)</td>
<td></td>
</tr>
<tr>
<td>VOL</td>
<td>1</td>
<td>Voluntary work</td>
<td></td>
</tr>
<tr>
<td>GAP</td>
<td>1</td>
<td>Gap year before starting HE</td>
<td></td>
</tr>
<tr>
<td>EDU</td>
<td>1</td>
<td>Traineeship</td>
<td></td>
</tr>
<tr>
<td>EDU</td>
<td>2</td>
<td>Apprenticeship</td>
<td></td>
</tr>
<tr>
<td>EDU</td>
<td>3</td>
<td>Supported Internship</td>
<td></td>
</tr>
<tr>
<td>EDU</td>
<td>4</td>
<td>Other FE* (Full-time)</td>
<td></td>
</tr>
<tr>
<td>EDU</td>
<td>5</td>
<td>Other FE* (Part-time)</td>
<td></td>
</tr>
<tr>
<td>EDU</td>
<td>6</td>
<td>HE</td>
<td></td>
</tr>
<tr>
<td>SDE</td>
<td>1</td>
<td>Supported independent living</td>
<td></td>
</tr>
<tr>
<td>SDE</td>
<td>2</td>
<td>Independent living</td>
<td></td>
</tr>
<tr>
<td>SDE</td>
<td>3</td>
<td>Learner returning home</td>
<td></td>
</tr>
<tr>
<td>SDE</td>
<td>4</td>
<td>Long term residential placement</td>
<td></td>
</tr>
<tr>
<td>OTH</td>
<td>1</td>
<td>Other outcome – not listed</td>
<td></td>
</tr>
<tr>
<td>OTH</td>
<td>2</td>
<td>Not reported</td>
<td></td>
</tr>
</tbody>
</table>

4.19 The list of suggested positive outcomes is intentionally broad at this stage as a first step in the transition from payment by qualifications. This proposal has raised concerns that providers will just be incentivised to move people into further learning (particularly in a difficult labour market) or into ‘easy’ options such as volunteering. In part, this is one of the risks that would need to be accepted and monitored. From the outset it will be important to establish the current volume of progression into various outcomes, to act as a benchmark against which any change in behaviour would be measured.

4.20 Commissioners also have the option to define the range of acceptable outcomes based on the target group or strategic priority. For example, if funding was prioritised towards job creation then the definition of a positive destination might be sustainable employment of $x$ hours a week for $y$ weeks. Or, for example, commissioners were funding a course aiming to increase social capital amongst disadvantaged groups then ‘volunteering’ might be the selected positive destination used in the contract. The only issue in regard to varying positive outcomes by contract us that it introduces an additional level of complexity to the funding arrangements. Stakeholders consulted for this project suggested that such additional complexity may not be desirable.

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47 SFA (2014) *ILR specification, validation rules and appendices 2014 to 2015*
Refocusing funding on SMEs

4.21 In its Jobs and Growth Plan the LEP recognises that increased delivery costs can act as a disincentive for providers to build relationships with SMEs to upskill their employees. Yet one of the key objectives for this project is also to focus on the LEP’s priority that no Londoner or London business is left behind. Therefore ways to strengthen relationships between SMEs and FE and skills providers must be considered.

4.22 The first way in which this objective could be achieved relates to the proposal within the LEP Jobs and Growth Plan, which is to make differential payments to providers in line with delivery costs. For example, within the current 19+ apprenticeship funding methodology providers are paid 25% less for large employers (based on a list maintained by the SFA of employers with 1000 or more employees). In this model providers would be paid more through a smaller employers would be paid more as an ‘SME’ funding uplift to better reflect the higher costs of delivering to small businesses.

4.23 However, as discussed in chapter three, altering provider funding models is just one way of achieving the objective of strengthening the SME-FE relationship. An alternative might be to create greater incentives to engage from the employer side via a ‘bonus payment’ to the SME, to put towards the cost of provision. For example, within the current apprenticeship funding methodology there is a £1,500 Apprenticeship Grant for Employers (AGE). This can pay for up to 10 apprentices (£15,000) for 16-23 year-olds apprentices at SMEs employers that have never taken on an apprentice before. As government introduces mandatory fees for employers, SME’s would use their grant or bonus payment to offset some or all of the employer fee but the provider would still be paid the full fee.

4.24 We recommend the LEP trials an approach based on the first approach - paying providers less for delivering training to large employers and then using the savings from this approach to make a payment to the small employer to create a demand for skills and driving engagement through funding but from the perspective of the employer, rather than the provider.

48 For further information http://feweek.co.uk/2014/05/28/employers-to-fork-out-for-a-third-of-apprenticeship-training-as-government-tells-bosses-to-pay-providers-for-first-time/
Test, learn, adapt

4.25 ‘Test, learn, adapt’ is a concept, borrowed from behavioural insights approaches, best set out in the Cabinet Office paper of the same name.\(^{49}\) Within ‘test, learn, adapt’ once desired outcomes have been defined and the context understood, different ways to achieve those outcomes are tested, lessons are learned from successes and failures (the risk of failure must be tolerated) and models are adapted in response to feedback.

4.26 This concept is relevant to this project as we have made a set of recommendations above that the LEP can test immediately and the learning from which has the potential to influence skills funding policy more widely. It is also relevant to thinking about longer-term reform and the scope and appetite to do more in the PbR space; it is evident from previous chapters that there are many uncertainties around incentivising skills funding. As discussed earlier, payment by results is one of the key mechanisms, and includes itself includes many variables such as:

- Apportionment and balance of payments between different elements: attachment/enrolment; delivery costs; outputs (qualifications etc); outcomes
- Definition of payment triggers
- Data quality and availability to substantiate payments
- Targeting, for example of groups with specific characteristics
- Payment adjustments or ‘tariffs’ for example to reflect higher delivery costs or incentivise particular behaviours
- Payments in relation to individual, contract or other (for example sub group) achievements

4.27 Across skills provision (and similar services such as employment support) there are contrasting examples of how systems have been devised and implemented using different approaches and factors, many of which have informed our discussion of issues in London and identification of different possible models. The variability of systems, scarcity of hard evaluative information, and application to different types of individuals in different local economies/labour markets however makes it difficult to identify clear criteria to use when designing PBR systems, and to assess the effects of, for example, changing payment ratios. For example, the current national skills funding

\(^{49}\) Haynes, L; Service, O; Goldacre, B and Torgerson, D (2012) Test, Learn, Adapt: Developing Public Policy with Randomised Controlled Trials, Cabinet Office Behavioural Insights Unit
system has an 80:20 split between enrolment and qualification attainment payments. But why is it not 70:30 or 90:10? Does introduction of a given level of incentive influence behaviour immediately or only after a period of time (for example when the implications of non-achievement become clear)? Does impact on performance persist or need 'refreshing' by imposition of more stringent conditions over time?

4.28 As raised in paragraph 4.13 above, we therefore recommend that BIS, the SFA and LEP officers work together to design a number of carefully selected pilot projects to test different incentivisation models and variables within them, using the new ESF programme. ESF has a number of characteristics and advantages for the London LEP to take a lead in creating a more responsive and effective skills funding regime:

- ESF is intended to complement existing mainstream programmes and has specific provision for piloting, experimentation and innovation. London’s European Structural and Investment Funds strategy (ESIF) already includes provision for an ‘Opt-in innovation pot’ designed to test new approaches, citing in-work progression as an example, and sets a requirement on Opt-in match funding providers to work with the results of this study. The groundwork for piloting through ESF is therefore already in place, including allocation of funds to cover additional ‘research’ costs;

- The London ESIF contemplates spending up to £200m to be supported by SFA on skills development up to 2020, including £110m specifically related to career progression for low skills and low pay groups and for progression into intermediate, higher level and advanced skills training. These are precisely the sorts of college based provision which currently lack robust incentivisation mechanisms, and the level of spend contemplated provides more than adequate scope for development of pilot schemes;

- ESF’s time frame, with spend possible up to the end of 2023, provides an opportunity to run pilot provision for long enough to track longer term outcomes and to introduce modifications to experimental approaches over time;

- ESF’s audit and monitoring requirements dovetail well with the ILR record system and for those bodies with existing ESF delivery experience would mean the existence of robust data capture systems which could be readily adapted and exploited for pilot research purposes;

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- London’s colleges and other skills training providers are mostly experienced in the requirements of ESF provision and could be expected to be able to deliver appropriate projects without too much difficulty;

- ESF, as an inherently transnational programme, commands interest and policy transfer across Europe and can be expected in the new programme to include (as yet undefined) opportunities for transnational projects and exchanges of experience. A major incentivisation pilot in London could be expected to be influential in the transnational arena, and also be able to learn from parallel initiatives in other countries. It is known that the UK Government and the European Commission are keen to fully exploit EU funds’ ability to innovate, but that Member State plans so far in the 2014-2020 development process are not particularly strong in this respect. A major innovative initiative in the area of skills incentivisation from London could be expected to be well received at both national and EU level.

4.29 Assuming the principle of piloting is of interest to the LEP, we would welcome the opportunity to work with the GLA to identify the most appropriate areas and models. Pilots would need to be designed within the context of learning derived from other programmes and pilots. This includes the various reports on the Work Programme, forthcoming outcomes from the BIS LEP Skills Funding Incentive Pilots in West of England, North East, and Stoke and Staffordshire, and DWP trials of the impacts of employer engagement and access to careers advice on in-work progression. At this stage however we have identified three main areas on which pilots could focus and within each, a set of specific issues for testing:

Redefining outcomes

- Feasibility of paying for outcomes relating to in-work progression. In the USA wage progression is a standard part of outcome-based funding but in the UK there is less of a track record of pay related to achievement of qualifications. Pilots should aim to test the link between training and wage progression. The link may be stronger in certain sectors i.e. within high level skills and professions but also within low-income sectors where achievement of job-specific qualifications leads to increased hours/earning.\(^5\)

There is also value in piloting how payments may be made on the basis of other forms of in work progression. There is no single definition of labour market or job progression. Typically, measures of progression focus on one of three things:

\(^5\) Some London boroughs are in the early stages of discussing how best to support residents on low income jobs claiming Housing Benefit to progress, as part of the Whole Place Community Budgets agenda.
changes in earnings (from increases in hourly pay or hours worked); changes in occupation and employment status; and changes in skills (specifically increased qualifications). The LEP may wish to test which are the optimal non-income based indicators and the balance or weighting between them in measuring progression.52

- Feasibility/desirability of provider-defined outcome payments: using ESF Families provision model, work with providers to define outcome expectations rather than impose a single, centrally-defined payment regime. Feasibility of verifying outcomes and associated administrative burden.

- Whilst timely access to robust, timely destinations data from government systems is some way off, ESF offers the opportunity to put additional funding towards developing and testing provider tracking systems, measuring administrative costs and disseminating best practice. This may best be funded through the Technical Assistance strand of ESF.

**Protecting the most disadvantaged**

- Targeting of particular priority groups and overcoming creaming and parking: comparison of different approaches to enrolment, progress and outcome incentivisation for defined priority groups, including narrowness of definitions, data tracking issues, levels of ‘tariff’ payments, value of small, highly focused provision against differential payments in larger generic provision.

- Creating a specialist market for supporting the most disadvantaged learners which could also address concerns about the impact of PbR on small and/or VCSE organisations. This may involve smaller organisations working in partnership, which has been found to be an effective mechanism to reduce the level of risk in PbR employment programmes internationally.

**Contract design**

- Measuring deadweight53 – a relatively unused concept in skills funding but critical in payment by results to ensure best use of public funds. Given the lack of current UK data on destinations of learners there is a question as to whether it is even feasible to estimate deadweight at this point. It may be useful to dedicate some ESF Technical Assistance funding to explore this issue further.

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52 Wilson, T et al (2013) *Work in Progress: Low Pay and Progression in London and the UK*

53 Deadweight refers to outcomes which would have occurred anyway, without the given intervention, and which therefore represent a waste of government funding.
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- Understanding the value of individual as opposed to contract performance payments. Linked to deadweight, what is the value of a contract target, could it function as a proxy for deadweight and at what level should it be set?

- Trialling differential ratios of programme:outcome funding with a particular focus on measuring the impacts on service quality and customer satisfaction as well as the impacts on different types and sizes of providers (i.e. public/private/VCSE and level of cash reserves and ability to bear upfront expenditure). Learning on the impact of greater PbR funding on job outcomes can usefully be fed in from programmes already commissioned through the SFA’s ESF Skills for the Unemployed funding stream.

4.30 Delivery of such a programme of pilots could relatively easily be structured into the current London LEP ESF strategy. We recommend that pilots are designed carefully to ensure potential replicability; meaning that they are of sufficient scope and delivered in a sufficient range of contexts to avoid results being too specific to be of wider relevance. Pilots would also need to ensure sufficient capacity and resources are available to track and report on results, outside of funding and resources for delivery. This sort of approach is well established in ESF practice.

4.31 The remainder of 2014 will be concerned with the LEP working up its ESIF programme, including detailed negotiations with Opt-in providers, notably SFA. With the Opt-in provider committed to creating programmes tailored to local needs and LEP priorities, there is clear space now for devising a programme able to seize the initiative in this important area.

Conclusions

4.32 The recommendations made in this chapter seek to balance the impetus and opportunity for immediate change with the need to spend time over the assumptions and processes underpinning a successful payment by results model. The recommendations have been tested with a workshop involving representatives of the SFA, London Councils, BIS, AOC, AELP, the GLA and a number of London colleges. Participants were encouraged to question and challenge the approach and their feedback has been reflected in this report.

4.33 We aim to recognise the broad contribution of learning to both the economy and society by ensuring that jobs are not the sole positive outcome rewarded by funding. We acknowledge areas where outcome measurement is more complex, particularly in terms of in-work progression, and highlight the vital importance and challenges of rigorous data collection. We incorporate learning from the implementation of outcome-based commissioning internationally and in other policy areas and advocate
further testing of ways to address the risks inherent to PbR, through the ESF 2016-20 funding stream.

4.34 Above all the recommendations in this report seek to create a common funding model which is flexible and responsive to employer demand and LEP priorities, whilst providing a sufficient level of stability to create a diverse provider market.
5 Conclusions

5.1 Debates about the need for reform of skills funding centre on the current prioritisation of qualification outcomes at the expense of broader outcomes relating to jobs and progression (in learning and in careers). Research suggests that UK skills policy has not always met the needs of employers or the local economy. Skills supply, demand and mismatch may be creating a disconnect between the skills we are producing and the skills the economy needs. At the same time, destinations data of learners is insufficient to give firm evidence to prove otherwise.

5.2 The recommendations made in this report are intended to send a clear signal to London’s FE and skills providers indicating a need for change by ‘redefining success’ in a way that is better aligned with objectives of the LEP, whilst continuing to recognise the wider benefits/positive outcomes from learning that are not just about entering work. To support providers to measure and demonstrate their contribution to local labour markets, there is an urgent need to prioritise tracking of learner outcomes in terms of entry to employment, length of time in employment and progression in work. These are two important changes, outside of the funding model per se, that can and should be implemented with immediate effect.

5.3 However there is also a clear impetus amongst commissioners for greater use of payment by results and whilst PbR is neither the only nor necessarily the best method of driving behaviour, it does offer the potential to drive efficiencies and innovation if correctly designed. Over time the LEP will therefore wish to keep the new system under review to explore the extent to which these proposals generate the desired level of change and to flex the funding model to ensure that objectives are achieved.

5.4 The design of an effective PbR system requires both learning from what has gone before but also the ongoing flexibility to respond to continued learning. This can be difficult to achieve in live running and for this reason a series of pilots operating alongside the mainstream is proposed. Through the European Social Fund, London has the scope to test underpinning assumptions, for kinks to be ironed out and, importantly, for providers to get on board. The key issues for testing and trialling are those that underpin the success or failure of a PbR system, such as, measurable outcomes, the ‘right’ balance of programme:outcome payments and how best to protect the most vulnerable learners.

5.5 In addition to the opportunities offered by the funding system it is critical that the LEP makes use of all the levers it has to create responsive skills provision in the capital. Ofsted has a vital role in robustly assessing providers’ engagement with employers and the extent to which learners are achieving positive labour market outcomes. Equipping Ofsted with destinations data will facilitate such assessments but there may
also be scope to increase the weight given by Ofsted to indicators of labour market responsiveness, such as level and quality of employer engagement, use of labour market intelligence and quality of careers information, advice and guidance. If these factors became critical in achieving a good or outstanding rating it is likely that providers would increase their focus on them.

5.6 FE and skills providers are key to successful delivery of any skills funding model, so the LEP should prioritise creating a strong dialogue between commissioners and providers, and their representative bodies. At the same time there remains a task to convince providers that there are issues to address and to explain how PbR is, at least in part, the solution. Drawing on the experiences of providers delivering the SFA’s ESF Skills for the Unemployed provision will be valuable in this respect.

5.7 A further driver of more responsive provision will also be greater (and better articulated) demand from employers for skills, both in terms of recruiting the unemployed but also upskilling their workforce. Although slightly outside the scope of this project, the proposal made in the report around SME funding seeks to use the funding system to create an incentive for employers to engage with providers.

5.8 Finally, whilst this report focuses specifically on London, the issues discussed here are of national importance. For example, for many years skills policy and delivery professionals have discussed how to increase the integration between employment and skills provision. The recommendations made in this report can make the first tangible steps towards genuine integration by starting to align outcome measures across employment and skills provision. "Agreed common measures would help minimise different performance, outcome and reporting requirements and facilitate co-commissioning and the alignment of skills and employment funding. They also would help facilitate greater coherence in the performance and outcome standards that providers have to meet."54

5.9 The outcomes of any reforms which result from this report will be of interest beyond the capital. London has the opportunity to act as a pathfinder in incentivised skills funding and to feed learning back to BIS and the devolved administrations, as well as internationally.

5.10 In summary, the LEP is recommended to:

- Redefine positive outcomes from skills provision towards employment and progression and away from achievement of qualifications – for all types of learning;

54 Finn, D (2010) Ibid.
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- Require the completion of learner outcome and destinations fields in the ILR system for all learners – including those currently in employment;

- Consider how to support London’s FE and skills providers to track destinations of learners in a cost effective manner with minimal administrative burden;

- Collate and share the learning from FE and skills providers delivering the SFA’s ESF ‘Skills Support for the Unemployed’ provision in terms of operating under PbR and destinations tracking;

- Continue to lobby government to provide timely access to central employment and earnings data;

- Conduct annual reviews of the impact of the above changes on the extent to which London’s skills provision is meeting LEP strategic objectives and assess the requirement for increases in outcome-based funding;

- Design and procure a series of ESF-funded pilots to test and evaluate the key principles and processes which will underpin a successful PbR model for skills funding;

- Engage with London FE and skills providers to discuss and debate the need for reform and to also champion the contribution that providers are already making to help learners to enter, sustain and progress in work;

- Advocate for increased weight to be given in Ofsted inspection to indicators of labour market responsiveness such as: level and quality of employer engagement, use of labour market intelligence and quality of careers information, advice and guidance.