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| Committee(s) | Dated: |
| Finance Committee – For decision | 20 Feb 2018 |
| Subject: Corporate Services: Incentivising Efficient Demand Management | Public |
| Report of: The Chamberlain | For Decision |
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Summary

This report assesses how specific charging methods could be applied to internal services within the Corporation arising from a request from the Finance Committee in June 2017 to consider such a scheme for legal services to manage demand.

There are a number of areas of analysis required to establish the suitability for introducing an internal charging mechanism and whether this will incentivise behaviour in order to manage demand. Our analysis has identified that internal charging is suitable for legal services and for project or ad hoc work requiring specific additional resources in other services. However, the charging mechanism is likely to vary between departments. A set of criteria has been developed which indicate when internal charging is beneficial and proportionate. Legal services meet the criteria for specific internal charging for all legal advice and support which the service delivers.

An internal trading account will be created for legal services. An income budget will be created within the Comptroller and City Solicitors local risk resource; and expenditure budgets in other departments across the Corporation.

Any future requirement to manage demand in other departments can be assessed using criteria set out in this report which may be particularly applicable to project or ad-hoc work which requires additional resources above and beyond business as usual requirements. It also needs to ensure that any charging mechanism does not deter departments from seeking appropriate legal, financial or other support service advice when needed.

Recommendations

Members are asked to:

1. Approve the creation of an internal trading account for the provision of all legal services by the Comptroller and City Solicitor.
2. Delegate authority to the Chamberlain to amend budgets to facilitate the legal services internal trading account.

3. Approve the principle that work above business as usual which requires additional corporate support service resource should be charged to the department/programme and to receive a further report on the detailed implementation.

Main Report

Background

1. As a public body the City of London Corporation must be able to demonstrate that it is achieving Value for Money (VfM) in the delivery of services. The way that the Corporation utilises its resources is central to this aim and being able to clearly link costs and outcomes supports this.
2. The Corporation is seeking to deliver VfM from corporate support services. SBR savings and efficiency plan savings have been delivered consistently by these services. It is important, however, that the right resources are in place to support the activity of the organisation in delivering the outcomes of the Corporate Plan.
3. Service departments operate a combination of business as usual activity, which is stable and predictable to a large degree, and growth or change programmes which create additional demands on corporate support services to enable these programmes to be delivered. To ensure resources are allocated in the most efficient way it may be prudent to incentivise behaviour, striking a balance between the additional costs of operating a charging mechanism and the economic benefits that arise.
4. This proposal seeks to balance the economics of demand management with the accounting required to operate a charging mechanism in an efficient and practical way.
5. Costing is an accounting technique that seeks to measure the use of resources by services, activities, contracts, processes etc. There are several methods that can be applied to quantify the cost of a particular activity or outcome. These costing methods are commonly applied in manufacturing where the costs and resources (inputs) associated with the production of a product (an output) can be quantified with relative ease. In service industries this becomes more challenging as inputs and outputs are more difficult to measure in a standardised way.
6. A full costing system assigns costs to services by allocating a share of operating cost to services based on an agreed apportionment method. This is the method used by the City to allocate central costs through recharges to services.
7. Most regulatory agencies and government departments typically require full absorption costing to allow comparison between organisations, segmental reporting and the setting of taxation rates. The advantage of absorption costing is to make stakeholders aware of the costs of public sector services and programmes, to ensure that statutory financial requirements are met and that appropriate revenues are received from government.

8. This report considers whether the application of an internal charging mechanism is appropriate for legal services and whether this could be applied to other services yet to be identified.

Main Report

9. There are a number of areas of analysis required to establish the suitability for introducing an internal charging mechanism. These need to be assessed and each satisfied on a case by case basis in order to be confident that such a charging mechanism is appropriate and proportionate:
 - i. Activity analysis: can the activity be easily quantified and recorded?
 - ii. Cost breakdown: are the costs known and can they be fairly attributed to the activity?
 - iii. Charging options: what is the aim of charging, e.g. full cost recovery, partial cost recovery (e.g. establishment costs only), and what will be the mechanism for setting and monitoring budgets?
 - iv. Business Plan: does the proposal for internal charges seek to generate a surplus and are there opportunities to develop external trading for services provided by the City?
 - v. The use of a cost centre or account code or job code to capture the financial activity of a service unit: Does the financial accounting system have the functionality to achieve this?
10. In practice, very few public sector bodies have introduced internal trading accounts as a mechanism to allocate the cost of support services across the organisation. This is viewed as being overly bureaucratic and delivers little value for money primarily due to the time required to capture the activity of an individual in a meaningful way. CIPFA guidance recommends the use of recharges to allocate costs to services, a practice which is well established in the City Corporation and which has the approval of our external auditors. Where internal trading accounts do operate successfully they are used to manage demand in addition to allocating costs.
11. Internal trading for public sector in-house legal services is a more widely utilised mechanism being appropriate due to the existing standard practice of time recording as is the case with the City of London legal division, this approach effectively manages and controls demand for legal services. Appendix 1 documents how the analysis suggested above has been completed to demonstrate that demand management can be achieved through the implementation of a trading account on a partial cost recovery basis. Should the demand for legal services continue to grow there will be a step-change where demand necessitates additional resources to meet demand, the cost of which would be funded by departments as they consume legal services.
12. In considering the merits of applying internal trading to other support services there must be an operational requirement which goes beyond technical feasibility,

e.g. demand management, to justify moving away from the recharging mechanism currently in operation. There are inherent costs to the process, so the benefit must outweigh these. And it is important that the mechanism does not deter departments from seeking appropriate legal, financial or other support service advice when needed.

13. Implementing internal charging across a department would create a significant administrative burden in order to capture the charging basis if the practice of time recording is not currently used. For most departments there would be little advantage gained by introducing internal charging for their business as usual work due to the administrative complexity this would create.
14. Taking the Financial Services Division as an example, it would be difficult to identify a customer or client for a large proportion of the business as usual work as this relates to corporate work with an impact across the Corporation. Being unable to accurately quantify and record activity and then fairly attribute the cost of this activity would preclude the introduction of internal charging for this work.
15. Additional demand pressures in support services can arise from additional work above business as usual driven by other departments or new corporate projects. Initiating this work has resourcing implications e.g. accounting, budget support, tax advice and conducting financial appraisals.
16. Where such additional work requires additional resources from support services, including Chamberlains, City Surveyors and Comptroller and City Solicitors, this must be quantified within the cost of the project and funded as an additional resource requirement, subject to assessment against the criteria in paragraph 9 and the approval of the relevant committees.
17. As we start work on the major projects there is a need to appropriately charge for the additional resources consumed. The mechanism for allocating funds to support these projects will be considered in a follow up report from the Chamberlain.

Proposals

18. The detailed proposal for the adoption of a trading account within legal services is documented in Appendix 1. This is a discrete proposal due to their ability to identify their customers, and specify which fund the work relates to, through their time recording software.
19. For work which requires additional resources from corporate support services this must be quantified within the cost of the project and funded as an additional resource requirement, subject to assessment against the criteria in paragraph 9 and the approval of the relevant committees. This will be simple to quantify as the costs will be above the local risk resource base and chargeable to the budget of the relevant project.

Corporate & Strategic Implications

20. The Corporate Plan states that as an organisation we need to be relevant, responsible, reliable and radical.
21. This proposal aims to ensure that we are responsible in the approach we take to managing our internal resources. This proposal does not seek to add a disproportionate bureaucratic burden on internal departments; legal services already operate a time recording system which is fundamental and which we are not proposing to roll out to any other department.

Conclusion

22. A request from Finance Committee was made to consider the implementation of an internal trading scheme for legal services as a mechanism to manage demand. Such a scheme has been assessed against a number of success criteria and could be implemented due to the particular way that legal services are delivered already by the Comptroller and City Solicitor.
23. Paragraph 9, above, defines a set of criteria by which the implementation of trading accounts can be assessed. Appendix 1 documents how these criteria are met by a legal services internal trading account.
24. Any future requirement for internal trading in other departments can be assessed using these criteria which may be particularly applicable to project or ad-hoc work where additional resources are required above and beyond business as usual requirements.
25. The introduction of a trading account will necessitate the creation of an income budget in the Comptroller and City Solicitors local risk resources and expenditure budgets in other departments local risk resources. The Chamberlain will oversee the implementation of these budget amendments.
26. Work above business as usual which requires additional resources from corporate support services should be funded as an additional resource requirement. A mechanism will be created to charge these costs to the Major Projects Reserve and a further report submitted to Finance Committee.

Appendices

- None

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Legal Services Trading Account

1. In Local Authorities legal services departments often operate internal trading accounts to manage demand. Within the London Boroughs Legal Alliance 6 of 9 legal services departments operate trading accounts. The conditions in paragraph 9 of the report can be fulfilled with relative ease, as described below:

i. Activity Analysis:

Legal services usually operate a time-recording system, KMX, to record time spent by an individual on tasks during the day. This allows the activity of each individual to be allocated to a task and recorded. The data from such a time-recording system can then be used to accurately charge clients. This is considered standard working practice throughout the legal services sector.

ii. Cost breakdown:

The costs of the legal services department can be quantified by analysing the local risk budget.

The current headcount in the Comptroller and City Solicitors Department is 49 FTE (55 employees). 43.4 FTE would fall within the scope of the internal trading account with the C&CS Finance (rent accounting) and Information Compliance teams being excluded.

iii. Charging options:

Full cost recovery would include the total cost of providing legal services plus internal recharges (as a proxy for overheads) within the fee setting calculation which, whilst appropriate for trading externally, does not offer any benefit within an internal charging regime. In fact, by including notional recharges the cost of legal services to other departments would be inflated.

Commercial trading goes a stage further than full cost recovery by including a profit margin. Any proposal would need to consider a pricing strategy to determine demand and charging within a local market.

The proposal for an internal legal services trading account will be on a partial cost recovery basis (i.e. establishment and direct costs of specified posts only). The C&CS Finance and Information Compliance teams within Comptroller and City Solicitor's department will be excluded from the trading account arrangement and a local risk budget will be maintained to support these teams and the teams would remain with the C&CS department

An hourly rate would be set on the basis of the cost of the service and would comprise a number of rates determined by staff expertise, these rates are currently in place. Annual income budgets will be set to recover the cost of the service within the scope of charging and will be reviewed annually within the budget setting process. Income budgets will be

monitored on a monthly basis in line with the existing Corporation arrangements.

iv. Business Case:

The proposal for internal charges is not seeking to generate a surplus from internal clients rather to rationalise internal demand for legal services. This proposal is not recommending to offer legal services to additional external organisations, for which a commercial charging model and business case would be required.

v. Capture financial activity:

A structure can be created in Oracle to support the management of charging and income through internal journals between legal services and client departments.

2. In addition to the wider consideration of the principles of internal trading there are practical considerations that must be worked through in detail to ensure that the management, including financial management, is robust. Issues to consider will include:

- i. The recording of transactions (and the use of Oracle journals);
- ii. The use of account codes to describe transactions;
- iii. The use of resources (surpluses) generated by internal trading.

3. There is also a requirement to ensure a clear delineation of responsibilities is defined for the parties involved:

- i. Customers: there is a Service Level Agreement (SLA) in place which details and specifies what services are being purchased, the cost and timescales involved and how to deal with complaints which has been presented to client department management teams over the last three months but would doubtless require further refinement were the service to move to a trading account arrangement.
- ii. Providers: relationships with customers are managed with the existing SLA and comply with the Law Society LEXCEL quality standard on customer care; this would require minimal further refinement.
- iii. Finance Units: how will any additional administrative burden be managed, will additional resources be required to manage the process?

Options

4. The options identified to implement an internal trading account within legal services are:

- i. Do nothing.

The current demand for legal services is above the capacity the department is able to supply. An additional request for resources was approved by Policy and Resources Committee in May 2017 and Finance Committee in June 2017. If demand continues to increase it is inevitable that additional resource requests will be required.

ii. Implement internal trading for legal services.

This proposal sets out the rationale for introducing internal trading within legal services as a mechanism to manage the demand for the service on a partial cost recovery basis. Should additional resources be required to meet continued increases in demand this would be funded through charges to departments and/or projects rather than an increase in the resource base for legal services. Temporary staff assignments could be used but recharged directly to departments under the recharge arrangements to allow the resource to flex to meet demand spikes created by new initiatives and projects. This will improve the agility of the service and may reduce the requirement to outsource work at higher cost to the organisation.

The main risk from implementing such a scheme arises from the desire to reduce demand for legal services. This could result in legal advice not being sought when it is required which results in the increased risk of reputational damage, a potential legal dispute and/or financial penalty.

The risk of being unable to deliver this proposal on a practical basis is low as legal services currently operate a time recording system which forms the basis of the data which drives the charging mechanism.

5. The recommendation is to pursue internal trading within legal services.

Proposals

6. For a legal services trading account to be implemented successfully a number of new budget lines will need to be created. An income budget will be created in the Comptroller and City Solicitor's local risk budget. Charges will be set in bands reflecting the seniority of the lawyer engaged on the task. Expenditure budgets for legal services costs will be created in departments who consume legal services.
7. This proposal will be cost neutral at the outset as the expenditure budgets will be calculated on the basis of historic consumption of legal services the total of which will equal the income budget. (A contingency fund could be top-sliced from the budget allocations for departments to smooth the cost allocation during the first year of operation of the scheme or to fund legal services work outside the scope of business as usual.) Departments will bear the cost of additional legal services work above the initial budget allocation from within their existing local risk resources.

8. Should the demand for additional work continue to grow within legal services there will be a point at which a step-change of demand necessitates the need to employ more staff to meet demand. Such an increase to the legal services establishment will follow the usual approval process through Establishment Committee supported by a business case demonstrating that the cost can be met from income. The risk of a decline in demand and a commensurate fall in income will be borne by the Comptroller and City Solicitor.
9. A project plan will need to be developed with internal departments to ensure that any change to the provision of legal services and the associated budgetary implications is communicated appropriately to avoid disputes being created. There is also a need to work with the Oracle team to critically assess the proposed method of implementation to ensure the technical implementation is streamlined and efficient.
10. Implementing internal trading will create an additional administrative burden which does not currently exist. The cost of preparing and processing charges (and responding to queries arising) will be minimised through the development of a streamlined process that will not require additional resources within the Comptroller and City Solicitor or Chamberlain's departments.