

ECONOMIC ANALYSIS OF CRIMINAL LEGAL ASSISTANCE

NOTE FOR PAYMENT PANEL

1. *This paper summarises the findings of a modelling exercise designed to assess the revenues and profits available to firms undertaking criminal legal assistance work. The exercise was carried out by SLAB staff in 2010. This paper is largely based on paper prepared for the SLAB Board at the time, a redacted version of which was released under FOI and subsequently published in 2013.*

2. *The data and analysis have not been updated and so are 'as was' in 2010. The paper is being shared with the panel at this stage to help stimulate debate. While the trends set out in the paper have shifted, the core findings remain valid in terms of the drivers of and range in profitability for firms of different structures. Clearly with less criminal business in the courts and lower expenditure on criminal legal assistance, fewer firms will be able to generate the revenues outlined in this paper. This makes the points made about market share even more pertinent than in 2010.*

EXECUTIVE SUMMARY

Key points

- The downward trend in firm and solicitor numbers has increased average funds available per firm operating and has helped maintain firms' profitability levels at a time of reducing overall expenditure.
- Both modelling and analysis of real firms shows high percentage gross profit margins for firms within the sector but partner heavy structures erode the per partner profits generated.
- Market share and firm structure explain more of the variation in profitability levels than does the fee system, which applies equally to all firms and across the country.
- However, the reduction in firm numbers and resultant changes to profitability has been uneven across Scotland. Loss of rural provision does not appear to be a great issue as amongst semi-rural firms we see some of the highest revenues generated by firms. This appears to be due to low competition in the market place.
- The structure of the market and how it interacts with the legal aid system means that partners wishing to develop a business with more junior solicitors carry a greater risk of business break up. This risk limits many firms' growth, their achievement of economies of scale and better per partner profits.
- Inefficiently structured firms with fairly low caseloads can still be profitable. However, further reductions in expenditure without greater market rationalisation or firm restructuring is likely to lead to pressure on profit margins for such firms.
- To the extent that they decide to withdraw from the provision of criminal legal assistance, this enables remaining firms to capture increased market share and therefore achieve higher revenues and profits.
- Conversely, an increase in fees could increase the attractiveness of criminal practice, lead to an influx of firms to the market and reduce profits for existing firms.

- The results of this exercise suggest that fewer firms, more efficiently structured, could deliver the same level of service and maintain profitability even if expenditure reduced.
- The means of achieving this market rationalisation and firm restructuring are beyond the scope of this project.

BACKGROUND

3. At its last meeting, Board Members considered a paper which reported on the findings of an exercise to validate firm cost assumptions previously considered by the Board. The paper also provided an analysis of the economic position of firms undertaking criminal legal aid on a national and sheriffdom basis, and considered trends in the composition, distribution and income of firms providing criminal legal assistance. The key points from that paper are set out in Appendix 1.
4. Members agreed that the full costing model should be updated with the validated firm cost assumptions and requested a report on the findings of that exercise at the next meeting. This paper sets out these findings and presents modelled figures showing the potential and actual profitability achieved from criminal legal assistance post summary justice reform.

MODEL OUTPUTS

5. Given variations seen in firm structures a number of potential profit levels exist for firms receiving similar revenues. Although revenues are similar, business structures differ impacting upon realisable profits. Two firms with very similar revenue profiles may have vastly different per partner profit levels. We recognise these variations and have identified three main factors that impact upon this:

- partners choices in regards to costs, including partner to employed solicitor ratios and solicitor to administrative staff ratios,
- case loads/market share
- the fee structure for criminal legal assistance itself.

6. The hypothetical firms illustrated in the tables below show modelled profits that indicate how variations in partner to employed solicitor ratios and administrative staff ratios can produce the same revenues with very different cost bases and how this impacts upon per partner profitability. This highlights the importance of business efficiency in maintaining profitability.

7. Within the modelling work, solicitor advocate income has been excluded. Solicitor advocate fees represent 3% of total criminal legal assistance fees paid to solicitors. However, the majority of firms derive no revenue from solicitor advocate work. Including revenue from this source would therefore misrepresent a majority of firms operating. In addition, while firm costs are unlikely to vary according to how a solicitor splits their time between solicitor and solicitor advocate work, the assumed revenues per solicitor from solicitor fees (as opposed to solicitor advocate fees) would be affected by any time spent conducting solicitor advocate work. This means that estimated solicitor advocate revenue cannot simply be added on top of projected solicitor fee revenue; the latter would have to adjusted downwards to compensate.

8. However, when showing the results of analysis of actual firms, we have included any solicitor advocate income. This has been done as the validated costs for these firms represent total costs incurred within the businesses. The total costs of these businesses, in some cases, include the provision of a solicitor advocate service. We also know the actual solicitor fee income generated and so do not have to adjust it downwards to compensate for solicitor advocate income.

9. It is worth noting that firms will also offer a private criminal service to accused persons who do not meet the criteria for publicly funded legal assistance; in some cases this is considerable. Private criminal revenue has been estimated as an additional 5% revenue on average. However, as we have no way of verifying this level of income, we have excluded it from modelling. Nevertheless, it is important to recognise that this revenue is generated at near zero additional cost to the business as the vast majority of costs are sunk costs that do not vary in line with case numbers. Overall profitability of firms will therefore be understated by the amount of private revenue obtained.

10. Additionally, many criminal firms also generate some revenue from children's and civil legal aid work, as well as privately funded civil work. As with solicitor advocate work, any time spent on these other areas will be time that is not available for criminal work and so we have not modelled any such income as part of criminal firms' profits. Nevertheless, it is likely that at least some additional revenue could be generated without increasing running costs: for firms with fully mixed practices, economies of scale may also be achievable by sharing costs across the business.

11. The following tables outline both hypothetical firm structures with projected costs and revenues, as well as verified firm structures. Real costs and revenues for these firms are shown. For the purposes of the projections in the tables below, the revenue aspect of modelling has been set at £100,000 per solicitor per year (ex VAT). This figure has been derived by looking at the average criminal solicitor fee revenue generated by 355 solicitors who undertake criminal legal assistance and no civil legal assistance. These solicitors represent over 99% of all criminal solicitor fees paid to criminal specialists. We therefore think the average is a reasonable projection of the revenue a criminal specialist can be expected to generate in a year.

12. It should be noted that at the lower end of this group are a number of solicitors who, although receiving no civil legal aid payments, may not in fact be full time engaged on criminal work, as suggested by annual earnings of between £5,000 and just below £20,000. There are several reasons why apparent criminal specialists would not be full time criminal lawyers. Our data shows, for example, that as many as 20% of all solicitors generating criminal legal assistance fees over each of the last few years have been doing so for either the first or the last time; their total earnings figures will therefore represent only a part year. Other 'criminal specialists', while not undertaking any legally aided civil work, may be acting for privately funded civil clients. Others may be trainees, work part time hours or have outside interests. While the very lowest earners have been excluded so as not to skew downwards the average used in the tables, it is likely that at least some of the remaining low earners are not in fact full time engaged on criminal work.

13. The actual practitioner described in Table 1 operates a firm in a semi-rural area, with 89% of the fund spend in the sheriffdom going to higher earning firms. For this

firm yearly solicitor fee revenues (ex VAT) over the last 3 years fluctuate between £33,000, in their start up year, to £83,000 for the financial year 2007-08 indicating profits of between £20,000 to £70,000. The verified gross profit margin for this firm was 6% in their start up year and currently sits at an 80% gross profit margin¹.

Table 1: Sole Practitioners - Modelled Results and Verified Comparison

| Partners | Employed Solicitors | Admin Staff | Costs² | Revenue | Profit | Per Partner Profit | Case Study |
|-----------------|----------------------------|--------------------|--------------------------|----------------|----------------|---------------------------|--------------------------------------|
| 1 | 0 | 0 | 27,294 | 100,000 | 72,706 | 72,706 | Model |
| <i>1</i> | <i>0</i> | <i>0</i> | <i>13,000</i> | <i>68,000</i> | <i>55,000</i> | <i>55,000</i> | <i>Actual</i> |
| 1 | 0 | 1 | 47,724 | 100,000 | 52,276 | 52,276 | Model |
| <i>1</i> | <i>0</i> | <i>2</i> | <i>69,348</i> | <i>265,000</i> | <i>195,652</i> | <i>195,652</i> | <i>Modelled Costs Actual Revenue</i> |

14. Also shown in the table is Scotland's highest earning firm with a structure similar to this firm, an Inverness based sole practitioner. The firm does not use agents as a matter of course and earned approximately £265,000 in solicitor's fees (ex VAT). Assuming 2 administrative staff, to ensure efficient running of such a high revenue generating business, and an office to operate out of this firm's costs could be modelled at around £70,000 per year. This would indicate that the largest bulk provider of this type can achieve almost £196,000 a year profit from their current criminal legal assistance work loads.

15. The actual 2 partner firm shown in Table 2 operates in a busy urban area. 49% of all solicitor fees in the sheriffdom go to higher earning firms making this firm an indicator of the mid way point in fund spend in the area. Yearly solicitor fee revenues (ex VAT) over the last 3 years fluctuate between £299,000 and £332,000 (ex VAT). Profit can be put at between £213,000 and £246,000 per year for the firm (£106,500 to £123,000 per partner). This verified level of profit represents a 73% gross profit margin.

¹ Gross Profit Margin = Gross Profit / Total Revenue.

Within small businesses, in general, margins under 10% are concerning, 10-20% is regarded as adequate and over 20% is regarded as good.

² When looking at results from modelling we have to be aware that we are representing all costs to the business except variable case costs. Variable case costs are paid for under the system of outlays and in principal should balance out with revenue from outlays. By excluding variable case costs and revenue from outlays we arrive at a net nil effect from these components. It should also be noted that the cost assumptions for such small firms may significantly over-estimate costs, as it is assumed that they have premises and, for the scenario with admin staff, that those staff are full time. Having part-time admin staff would clearly lower costs and increase profits.

Table2: Two Solicitor Firms - Modelled Results and Verified Comparison

| Partners | Employed Solicitors | Admin Staff | Costs | Revenue | Profit | Per Partner Profit | Case Study |
|-----------------|----------------------------|--------------------|---------------|----------------|----------------|---------------------------|--|
| 1 | 1 | 1 | 98,669 | 200,000 | 101,331 | 101,331 | Model |
| 1 | 1 | 2 | 121,233 | 200,000 | 78,767 | 78,767 | Model |
| 2 | 0 | 1 | 66,505 | 200,000 | 133,495 | 66,747 | Model |
| 2 | 0 | 1 | 86,000 | 323,473 | 237,473 | 118,736 | Actual |
| 2 | 0 | 2 | 89,069 | 200,000 | 110,931 | 55,465 | Model |
| 2 | 0 | 4 | 135,000 | 334,000 | 199,000 | 99,500 | <i>Modelled Costs Actual Revenue</i> |

16. Scotland-wide the highest earning criminal only firm of this type is a semi-rural 2 partner firm taking £334,000 (ex VAT) per year in solicitor fees. With an office and a confirmed complement of 4 administrative staff, this firm's costs can be modelled at around £135,000 per year (assuming all administrative staff are full time). This indicates profits in the region of £199,000 (£99,500 per year per partner). Although higher than the modelled profits projected for firms with this number of partners, this demonstrates that while having more administrative staff (4 administrative staff instead of 1) can ease the load on a business, it does erode outright profit for firms.

17. The table also demonstrates the impact on per-partner profits of both solicitors in both real firms being partners. In a firm with one partner and one assistant, the partner is clearly able to make higher profits as the assistant generates more income for the firm than they are paid. There are in fact three more higher earning two solicitor firms, but each of them also derives some income from civil or children's work (and so they are not classed as criminal only). One of these firms is known to make extensive use of agents and so has a very different business model to the type of firm we are seeking to model. One of the other firms is known to be of more traditional operation and generates around £635,000 in fees, including around £43,000 in civil and children's fees. We understand that the firm has only one partner. Even if the other solicitor is paid significantly more than the average assistant's salary used in the model and the firm has a higher number of administrative staff to deal with the very high volume of business, this highly efficient firm will clearly generate profits very substantially in excess of those set out in the table.

18. It is also of interest that the 2 highest earning criminal only firms of their type, sole practitioners and 2 solicitor firms, are operating in smaller urban centres within rural areas. One can assume relatively low levels of competition, good market share and quieter courts play their part in these firms' revenue generating strengths. This

assumption would require verification and may be worth investigating to help improve system efficiency.

19. The firm represented in Table 3 is the 2nd highest earning firm in its sheriffdom and takes 3% of the sheriffdom’s total criminal solicitor fees. 5% of the sheriffdom’s fees are earned by the one higher earning firm. Although per partner profit is averaged at £92,000 we suspect that there are 3 senior partners and 2 junior partners in this firm. It is unlikely that all partners are equal equity partners in the firm; resulting from this there will be an uneven split in firm drawings. The gross profit margin for this firm is 48%.

Table 3: Larger Firms - Modelled Results and Verified Comparison

| Partners | Employed Solicitors | Admin Staff | Costs | Revenue | Profit | Per Partner Profit | Case Study |
|-----------------|----------------------------|--------------------|----------------|----------------|----------------|---------------------------|-------------------|
| 4 | 3 | 6 | 378,925 | 700,000 | 321,075 | 80,269 | Model |
| 3 | 4 | 7 | 435,437 | 700,000 | 264,563 | 88,188 | Model |
| 5 | 2 | 7 | 367,705 | 700,000 | 332,295 | 66,459 | Model |
| 5 | 2 | 11 | 458,287 | 700,000 | 241,713 | 48,343 | Model |
| 5 | 2 | 11 | 504,806 | 969,975 | 464,944 | 92,989 | Actual* |

** This verified firm has 4 trainee solicitors. In modelling this firm the trainees have been treated as non-fee earning admin staff as they incur cost and are not fee earning.*

20. Although high revenues are seen within the sector and are delivered with low costs it has to be recognised that the principals in firms have to operate in an efficient manner to achieve sustainable profits. It is important to contextualise the verified firms and avoid ambiguity in the results: these firms are well run firms and operate in a fashion dictated by partners in the firm and within the confines of the market in which they operate. They are only able to achieve their market share through a balance of competition levels faced and the skills of their solicitors.

PRINCIPLES DERIVED FROM MODELLING

21. Profitability Modelling can be used to anticipate the effects of fluctuations in case loads on fee income, the impact of inflation on costs and the potential financial results from changes in firms’ staffing ratios. The value here is that it can be used to predict and identify potential concerns within the market before they occur. Additionally it can aid financial planning and financial decisions in business structuring.

22. For example, the modelling indicates potential issues in regard to maintaining efficient firm structures. Where the industry average wages for an employed solicitor are around £36,000 per year, if able to secure sufficient caseload and willing to take the business risk, it is clearly financially advantageous for an employed solicitor to seek to become a moderately successful sole practitioner. If as a sole practitioner revenues over £65,000 (ex VAT) can be generated (or less if costs are kept to a

minimum), the solicitor would be assured of higher drawings than an average wage would provide.

23. Achieving and maintaining highly efficient business structures is therefore difficult as assistants may break away to form their own firms or call to be made partner, thus eroding potential profits per partner. This financial risk faced by firms may deter these firms from taking on assistants and administrative staff or may force them towards individually less profitable 2 partner structures.

24. One of the benefits of modelling is the ability to alter the revenue input settings for solicitors. This function of modelling simulates the variation in workloads seen by firms. In uplifting this setting to simulate increased case numbers, we can observe the impact on profits for firms able to achieve higher market shares.

25. Tables 4 and 5 show the effects of modelling results based on per-solicitor criminal legal assistance fee revenues of £119,580 excl. VAT. This figure is derived from analysis of criminal specialists i.e. solicitors undertaking only criminal work. It excludes the very top earners i.e. those that collectively generate 5% of all fund expenditure paid to criminal specialists. Their individual earnings (each over £330k excl VAT) skew the figures upwards and, while certainly full time engaged on criminal work, these solicitors cannot be regarded as in any way typical. Compared to the scenario in the tables above, the average also excludes a larger number of those undertaking only small amounts of work (a group collectively responsible for only 5% of the fund expenditure generated by criminal specialists, averaging payments of just over £10k each) as they are unlikely to be full time engaged on criminal work.

Table 4: Higher Volume Potential for Small firms:

| Partners | Employed Solicitors | Admin Staff | Costs | Revenue* | Profit | Per Partner Profit | Gross Profit Margin |
|-----------------|----------------------------|--------------------|--------------|-----------------|---------------|---------------------------|----------------------------|
| 1 | 0 | 0 | 27,615 | 119,580 | 91,965 | 91,965 | 77% |
| 1 | 0 | 1 | 48,045 | 119,580 | 71,536 | 71,536 | 60% |
| 1 | 1 | 1 | 99,311 | 239,160 | 139,850 | 139,850 | 58% |
| 1 | 1 | 2 | 121,875 | 239,160 | 117,286 | 117,286 | 49% |
| 2 | 0 | 1 | 67,147 | 239,160 | 172,014 | 86,007 | 72% |
| 2 | 0 | 2 | 89,711 | 239,160 | 149,450 | 74,725 | 62% |

Table 5: Potential for Medium size d firms:

| Partners | Employed Solicitors | Admin Staff | Costs | Revenue | Profit | Per Partner Profit | Gross Profit Margin |
|-----------------|----------------------------|--------------------|--------------|----------------|---------------|---------------------------|----------------------------|
| 2 | 4 | 4 | 350,000 | 717,481 | 367,481 | 183,740 | 51% |
| 3 | 3 | 4 | 316,134 | 717,481 | 401,347 | 133,782 | 56% |
| 4 | 2 | 4 | 282,268 | 717,481 | 435,213 | 108,803 | 61% |
| 5 | 1 | 4 | 248,402 | 717,481 | 469,079 | 93,816 | 65% |
| 2 | 4 | 6 | 395,291 | 717,481 | 322,190 | 161,095 | 45% |
| 3 | 3 | 6 | 361,425 | 717,481 | 356,056 | 118,685 | 50% |
| 4 | 2 | 6 | 327,559 | 717,481 | 389,922 | 97,481 | 54% |
| 5 | 1 | 6 | 293,693 | 717,481 | 423,788 | 84,758 | 59% |

26. The above table shows 8 firm structures with identical combined solicitor/partner numbers and potential revenues (£717,481 per year) and demonstrates clearly the impact on profits (and particularly per partner profits) of varying the partner/assistant ratio. Although we do not have partner information across the profession, we would suggest that criminal firms are less likely to adopt the most profitable structures, even where there are multiple solicitors.

27. 9 firms achieved this revenue level in 2008-09 from criminal legal assistance alone. In total they received 10% of all criminal legal assistance solicitor fee payments across Scotland in the year.

28. The smallest of these firms was a 3 solicitor firm receiving £750,000 (ex VAT) in solicitor fees (revenue of £250,000 per solicitor). This firm undertook no civil legal assistance and focused on criminal work. Assuming all 3 solicitors are equal equity partners and the cost associated with employing 3 additional solicitors the minimum per partner profits would be at minimum £129,000 per year. In reality this approach could overstate costs by more than £108,000 (the cost of employing 3 assistants/solicitors).

29. The largest firm earning over £705,000 last year was a mixed practice firm that received £835,000 (ex VAT) in criminal legal assistance payments. This was earned across 13 solicitors. 88% of these payments were registered to 3 solicitors, presumably the partners (from the breakdown of these payments 1 senior partner & 2 junior partners can be deduced). It would appear all other solicitors undertake part time criminal legal assistance work along side civil legal aid and other private cases. The practice of partners signing cases protects the firm from a loss of cases to solicitors that may leave the firm taking clients with them.

30. Rotating assistants in and out of criminal legal assistance gives a rounded legal knowledge to those employees and protects the firm against clients being enticed away from the firm by specialist junior employees. Profitability modelling has its limitations under these circumstances (as it is very difficult to estimate the proportion of each solicitor's time that is devoted to criminal work) but the core principles remain solid. Keeping partner numbers low ensures higher per partner profits.

31. If a firm has good market share and at the same time maintains the margins shown in the table, criminal legal assistance work provides sustained profit. However, we need to bear in mind that potentials may not be realised in actuality, decisions made by partners in the running of their firms and the current market structure under which criminal legal assistance is provided impacts upon realised potentials.

32. The fact that firms of identical structures appear more or less profitable when using the attainable caseload function within modelling indicates that resource utilisation and the ability of a firm to attract clients and maintain case load levels is an important issue for firms in terms of maintaining per partner profit levels from criminal legal assistance. Some firms achieve their case load potential and maximise resource usage and other firms are achieving lower levels of business. Although these firms maintain good gross profit margins they are unlikely to achieve the higher potential per partner profits from criminal legal assistance alone. Under these market driven circumstances firms are either less profitable or move towards mixed practice models in order to maximise resource utilisation.

33. The number of firms achieving per solicitor revenues higher than those used in the table demonstrates that solicitors in a well run firm have capacity to generate very substantial profits under the current criminal legal assistance system. The greatest challenge for many firms will be achieving sufficient market share to realise these profits. This is made more difficult by the sheer number of firms (and solicitors) in the criminal market, especially post summary justice reform.

CONCLUSIONS

34. The analysis of both real firms and modelled outputs presented above show that the current criminal legal assistance system is clearly capable of allowing firms to generate good percentage gross profit margins. These figures do not necessarily translate into quite such impressive per partner drawings as partner heavy ratios erode the per partner share of profits generated. However, for partners wishing to develop a business with more junior solicitors the risk of business break up is enhanced. This, combined with a large number of firms competing for a finite number of cases, is limiting many firms' growth, their achievement of economies of scale and better per partner profits.

35. As things stand, the payment structures for criminal legal assistance do little to promote the adoption of efficient sustainable business structures. Combined with relatively static payments per case this would lead to pressure on firm profitability unless accompanied by other changes in the market. As our previous analysis shows, the downward trend in firm and solicitor numbers over recent years has increased average funds available per remaining firm and has on the whole enabled them to maintain profitability levels.

36. Nevertheless, the number of firms and solicitors and the relative ease of entry into the market for new start-ups (assuming a ready made client base) combine to suppress market share and inhibit efficient firm structures, meaning that profits cannot always be maximised. This will contribute to a perception amongst many solicitors that the fee structure and level is insufficient to generate adequate profits. The narrowing limits of public expenditure suggest a need to resist calls for increased fees and instead to find ways of improving the profitability of firms within the existing fee levels, or maintaining profitability should expenditure fall. However, without more far-reaching restructuring of both the market and individual firms, including the adoption of more efficient business structures, partners can expect falls in per partner profit unless gaining market share. The challenge for the Board and Ministers is how to achieve this restructuring. A paper to the next Board meeting will explore how a contracting system might contribute towards this goal.

37. At present, where businesses are less efficient and competition is high practitioners' concerns over profits are to some extent justified. However, this appears to be linked to factors outside the control of the fee payment structure: firm structure, open market competition, poor market share and resultant lower case loads.

38. The observed reduction in firm numbers and resultant changes to firm profitability has been uneven across Scotland and is a finding worth further investigation. Loss of rural provision does not appear to be a great issue as amongst semi-rural firms we see some of the highest revenues generated by firms. This is due to low or no effective competition in the market place.

39. The provision of criminal legal assistance appears more at risk from a lack of drive towards efficient business and market structures and a lack of ability of firms to develop new practitioners than it does from the fees provided per case. The current legal aid system does little to promote sustainable efficient businesses even though such businesses do stand to make significant profits at current fee rates.

APPENDIX

PROJECT OBJECTIVES, RATIONALE AND MODEL VERIFICATION

1. Criminal firm profitability modelling has been developed as part of a wider project to conduct an economic analysis of criminal legal assistance. The project as a whole is designed to assist the Board in understanding patterns in criminal expenditure over time, across the country, and between different types of firm. This understanding in turn assists the Board in its function of advising Scottish Ministers on the operation of criminal legal assistance, trends in expenditure and the relationship between those trends and the supply base.
2. Specific objectives of the modelling of profitability were to:
 - identify sources and amounts of ‘typical’ costs incurred by firms providing criminal legal assistance;
 - combine these with ‘typical’ income from the provision of legal assistance to produce a model of profitability that could be adjusted to explore profitability at different income / expenditure level, for different types of firm and different periods of time.
3. All costs included within this modelling work have been verified by three accountancy firms from different regions of Scotland with differing urban-rural environments. Whilst it is recognised that an individual firm’s costs may vary from the costs held within our model, a consensus has been reached that the costs included provide a fair representation of the necessary real costs incurred by firms in the provision of criminal legal aid.
4. In addition to accountancy verification we have approached the partners of 10 firms providing criminal legal assistance and have sent firm-specific modelled costs to 9 of these firms. This firm level verification exercise confirmed that the assumptions we had made in regards to costs are broadly accurate, although as expected there were some variations from firm to firm. Some respondents stated that their costs for individual items were slightly lower than our assumptions or were not incurred at all, whereas others stated that their costs were slightly higher than assumed. In almost all cases, this was either because of differences between the firm’s actual structure and our assumptions about the firm (one firm had trainees of which we were unaware, while another did not have any premises and so had significantly lower costs) or choices made by partners about expenditure that cannot be regarded as necessary for the provision of a criminal defence service.
5. The Board recognises that some variation will exist as a result of individual choices in firm structuring and spending patterns that may not be representative either of other firms in the market place or an optimally structured and run firm. Some firms will be incurring costs that may not be deemed reasonable or necessary under a tax payer funded system but we also recognise that minor variations from the costs we have verified will exist. The model does not seek to achieve an exact match in costs for every firm; we are trying to ensure a close approximation of average costs in order for us to make informed comment on the overall return provided by the current fee structure and market conditions.

6. As all firms operate in a system with a generic fee structure and level, it is appropriate that a model that may be used to assess the appropriateness of the existing fee structure and level should be based on averages. While some firms may have lower costs and therefore higher profits, others will have higher costs and therefore lower profits. However, this is to some extent down to choices made by firms and other factors that are not dictated by the fee system.
7. Our understanding of criminal legal assistance firms and their cost bases allows us to monitor the overall adequacy of criminal legal assistance payments. This in turn informs us of the profit margins that are achievable in criminal legal assistance work and how changes in either the fee system or the wider economic environment are impacting on firms. From this we can tell if firms are able to maintain sustainable profits from criminal legal assistance and whether tax payer money is being spent efficiently, whilst ensuring access to justice for accused persons.

CORE PRINCIPLES AFFECTING FIRM STRUCTURES & PROFITS

8. Financial modelling shows that profitability for firms providing criminal legal assistance (CLA) is highly reliant upon a few key factors. Put simply it is dependent on:
 - the effective management of firm costs;
 - the ratios of fee earning solicitors to non fee earning administrative staff;
 - the ratios of salaried solicitors to profit-sharing partners;
 - the market share a firm has/ number of cases it does;
 - the average expected income that a case will generate.
9. These can be broken down into cost or revenue factors, the first three items being cost related and the final two income related.
10. Although linked to and reliant upon the fee structure for criminal legal assistance all but the last of these factors are affected by a number of additional factors that are external to the legal aid system and fee structures in operation.

Management of firm costs

11. Through financial modelling it has become apparent that the key driving costs of a firm offering criminal legal assistance are salaries of employed solicitors and administrative staff. None of the cost verification work has identified variations in assumed wages as an issue. As such the core structure and main components of our cost modelling have remained stable throughout all adjustments.
12. All firms employing full time members of staff will incur 40% to 70% of the total costs on wages. As such the key driving cost for solicitor firms are staff salaries in the form of employed solicitors, salaried partners or administrative staff. This percentage figure excludes the cost of providing pensions (if a contribution is made by the firm) and excludes the cost of accommodating the staff and supplying them with the necessary equipment for their work.

13. In terms of costs, wage cost and wage inflation have to be regarded as the number one concern of any criminal legal practice; all other costs and the inflation/deflation linked to them are secondary to the wages paid out by a firm.
14. An extended period of low inflation, the recession, associated job cuts and job insecurity within the legal sector has led to downward pressure on wages and as such the trend appears to be for solicitor wages to remain static. The same applies to administrative staff wages. Wage inflation has not been a significant concern and should not be until unemployment drops and interest rates start to rise. Thus at present the main cost for criminal legal assistance providers is likely to remain steady. For criminal legal assistance firms a greater risk to profitability is that employed solicitors may leave, resulting in their old firm having to meet fixed costs (such as premises) from reduced revenues.
15. In some firms, staff costs may actually have fallen as a result of the recession if wages, hours or staff numbers have been cut. The reduced inputs required for an average case post summary justice reform – due to an increase in up front guilty pleas – may also have enabled some firms to reduce employed solicitor numbers while maintaining market share. This, along with a reduction in bureaucracy as a result of both the fall in advice and assistance applications and the rise of legal aid online, may also have facilitated a reduction in administrative staff numbers or hours. For the purposes of the model, we have assumed no such change and kept staff costs steady.

Staffing Ratios

16. The ratios of partners to solicitors (known as ‘gearing’) and fee earners to administrative staff are imperative to cost control and in turn the potential profitability of criminal legal aid firms. This fact has been highlighted year on year through The Law Society’s Cost of Time surveys. Firms will perform better financially if the partners manage their staffing ratios effectively.

Market share

17. Over 5 years there has been a 23% reduction in the number of firms undertaking criminal legal aid across Scotland. 160 fewer firms provided criminal legal aid in 2008-09 than in 2004-05. The profession is however not homogenous and can be characterised in several ways. For the purposes of this paper, we have used revenue levels as an initial measure on which to describe the market as a whole; we then go on to consider regional variations.
18. The structure of the supply of criminal legal assistance can be usefully analysed by considering four types of firms that deliver criminal legal assistance based on their work volumes and what other legal work we know that they do:

| | Criminal specialist | Mixed practice |
|----------------------|---|--|
| High business volume | High volume specialists that provide significant amounts of criminal legal aid (over £100k per year, | High volume mixed practices that provide large volumes of criminal legal aid (over £50k per |

| | | |
|----------------------|---|--|
| | with any civil legal aid income adding less than 10%). | year) alongside other legal services (adding at least 10% to their total legal aid income) ³ . |
| Low to medium volume | Medium volume specialists that focus solely on the provision of a criminal legal aid service, taking between £50-100k per year from criminal work. | Low volume mixed practices that provide some criminal service (less than £50k per year) alongside other legal work. |

19. As the table below shows, across Scotland the largest group of firms offering a criminal legal aid service consists of low volume mixed practices. 54% of all firms in 2004-05 fell into this group; this had fallen to 44% of all firms last year. The combined market share for these firms is just 4.3%. By way of contrast, the vast majority of cases are undertaken by a minority of the firms. These firms are either specialists or high volume mixed practices. 50% of the total fund spent on criminal solicitor fees went to 68 firms all of which had revenues over £350,000 in 2008-09: this represents 50% of the spend going to 12% of the firms providing a criminal legal service.

| Firm Type | Approximate Number of Firms 08-09 | Approximate % Market Share 08-09 |
|-----------------------------|--|---|
| Low volume mixed practice | 236 | 4.3% |
| Medium volume specialist | 37 | 3.4% |
| High volume mixed practice* | 134 | 36.8% |
| High volume specialist* | 134 | 55.5% |

* 268 firms command 92.3% of the market share between them. The other 273 firms undertaking criminal legal assistance command 7.7% of the market.

20. The reduction in firm numbers has been focused upon the lower revenue firms with a loss of 38% of the firms that undertook less than £50,000 worth of work per year. Unless overheads are kept very low, £50,000 in fee income is unlikely to support a solicitor full time engaged in criminal legal assistance. At the very low end of the market, there has been a 63% reduction in the number of firms receiving less than £1,000 in criminal legal assistance fees.

³ A number of such firms are paid significant sums in relation to children's legal assistance. For most firms, children's legal assistance is provided alongside both civil and criminal legal assistance. A small minority of criminal specialists (those with insignificant civil income) have significant children's legal assistance income. It is highly likely that this work relates only to offence-based grounds of referral and so is another aspect of their criminal legal assistance business. This is clearly a source of additional income for those firms.

21. By way of contrast to these very marked reductions in low-end providers, there has been a far less significant reduction in firms receiving over £50,000 in criminal legal assistance fees – just 5%, or 16 firms, over the last five years. This means that there has been a shift towards higher volume provision, with lower volume lower revenue firms ceasing to provide the service. This indicates an increased trend towards specialisation and a move away from the provision of low volumes of criminal legal aid within more generalised mixed practice firms⁴.
22. Nevertheless, there remains a large number of low to medium volume firms in the market. With good cost control and sufficient caseload, a small specialist practice can still be profitable. By ensuring that no more solicitor resource is put into criminal work than caseloads justify, a mixed practice can also achieve good profits from a small amount of criminal work. However, the profile of providers overall suggests that, while it is moving towards increased specialisation, the criminal market has not yet achieved optimal efficiency. The following section explores some of the reasons for this.

FIVE YEAR CHANGE IN REGIONAL MARKET PROFILES

23. It is worth keeping the above principles in mind when looking at the profile of firms operating in regional markets and how this has changed over the last 5 years. Change in the composition of firms undertaking criminal legal assistance work is shown in (Appendix 2).
24. Key points to pick out from this appendix are that 160 fewer firms offer a criminal legal assistance service than 5 years ago. The shift in market profile means that 144 fewer low earning firms are operating in the sector with a reduction of 16 firms that earned over £50,000. This is an indication of shifts towards higher volume provision.

Regional analysis

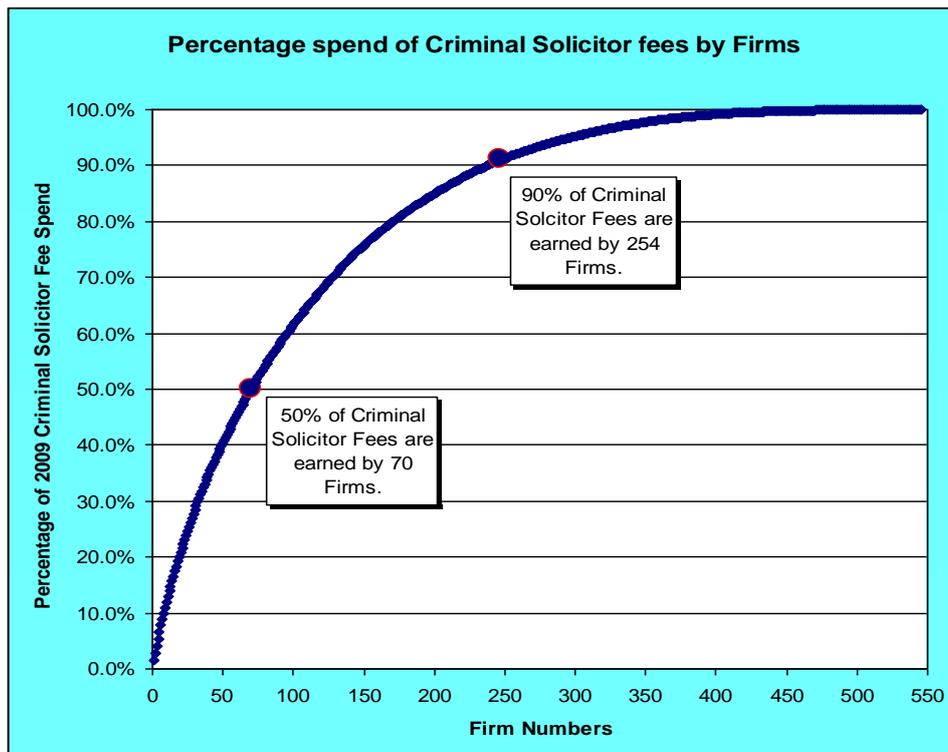
25. The regional analysis breaks the national market down into 6 sheriffdoms: Glasgow, Grampian Highlands & Islands, Lothian & Borders, North Strathclyde, South Strathclyde Dumfries & Galloway and Tayside Central & Fife. Firms' location within these sheriffdoms has been allocated by the postcode of the firm's head office. Few criminal legal assistance firms have offices in more than one sheriffdom.
26. Per case revenues have not increased in several areas of criminal legal assistance, particularly when taking inflation into account. However, volume changes and changes in the number of firms mean that average firm revenues have risen. Lothian & Borders is a good example of this. In 2004-05, 82 firms took an average of £134,000 in criminal solicitors' fees. This had risen to £192,000 in 2007-08, averaged across 67 firms, and further to £206,000 in 2008-09, averaged across 60 firms. In total this represents a 53% increase in average firm earnings

⁴ Over the last year this may be in part down to a reduction in general practice legal firms offering criminal legal aid linked to the recession. Redundancies in mixed practice firms linked to cost saving measures undertaken by these firms may have left less spare capacity and resource to pick up criminal legal aid work.

over 5 years. Index linking this rise, to take account of inflation⁵, firms have seen an inflation rate adjusted rise in average revenue of 42%.

27. Scotland wide there was little change at the top end of the market and only 4 fewer firms received over £200,000 in fee income - a 4% fall. This indicates that highly specialised firms have remained fairly static in terms of revenue generated and the drop out of firms at the lower end of the market has been absorbed by mid range firms, thus a middling of the market has occurred over that time. Variations from sheriffdom to sheriffdom are noticeable within this national trend with Grampian Highlands & Islands, Lothian & Borders and Tayside Central & Fife experiencing higher drop out rates for firms than the other 3 sheriffdoms.

Graph 1: profile of spending across firms:



28. During the 12 month period directly post summary justice reform 541 firms were paid for criminal legal assistance work. Payments are not evenly distributed across providers, 90% of fees were received by 254 firms (47% of firms), with 50% of the fees going to 70 firms (13% of firms). This indicates that a disproportionately high level of revenue is generated by relatively few providers. Clearly firms are engaged in the provision of criminal legal assistance to varying degrees. This is highlighted by the fact that the lowest volume provider received only £32 in fee income from criminal legal assistance; obviously they are not representative of criminal legal providers as a group.

⁵ This is done through the use of the UK treasuries GDP deflator, an Office of National Statistics tool for measuring the effect of inflation on the relative worth of set values over time.

MARKET ANALYSIS

29. Market analysis has shown that the ability of firms to achieve economies of scale, effective business models and potential efficiency savings are in part hampered by the openness of the criminal legal aid register. Relatively low start up cost and the relatively low business risk a solicitor encounters when breaking away from existing firms mean that although economies of scale are attainable often they are not sustained.
30. As seen in Table 1 in the main text, a low cost firm bringing in approximately £70,000 in fee income can generate profits of £55,000 a year from criminal legal assistance. If willing to take the business risk a good assistant assured of this workload would be rewarded financially by starting their own firm and achieving this personal income than working for the average wage of approximately £36,000 per year.
31. Although revenues, potential profit and verified real profits indicate adequate fees for well run businesses - achieving these efficient business structures is not always possible. This is down to the risk associated with the potential loss of fee earners, in a sector that is more likely to see business breakaways than business mergers. Because of this, the structure of the market favours small business with partner heavy structure. This pushes down the profitability of firms and reduces the stability of firms that do take on assistants.
32. In addition to this, the limitation on trainees' ability to generate revenues for firms hampers the development of efficient business structures leading to the perpetuation of partner heavy structures and leads to an underinvestment in succession planning. This in turn causes concerns for the future development of the sector and its ability to maximise profits.
33. It has to be noted that the current fee structures and levels can and do generate sustainable profits for firms even within a market that operates in such a way as to limit the development of economies of scales within firms and restrict potential for effective gearing (ratios). It is perhaps this, rather than the fee levels and inherent profitability of criminal work per se, that perpetuates the profession's calls for higher fees.

FIRM REVENUE TREND ANALYSIS

34. Data on criminal legal assistance revenue at a firm level shows that of firms receiving some amount of criminal legal assistance fees in the twelve months to August 2009, 58% received less than in the previous twelve months. Summary justice reform was intended to improve the efficiency of the criminal justice system across a number of different areas – including legal assistance expenditure.
35. A reduction therefore in firm earnings in this field was not unexpected following the reforms. However that only 58% of firms had a reduced income demonstrates that the reduction in income has not been evenly spread across firms – indeed, 42% of firms saw an increase.

36. The trend is in part driven by the reduction in firm numbers and over a 5 year period this has produced increases in average firm earnings in all sheriffdoms. On an index-linked basis, all sheriffdoms with the exception of Glasgow saw increases in average firm earnings over a 5 year period. Glasgow saw average firm earnings increase from £155K per year in 2004-05 to £163K per year in 2008-09. However in real terms, when taking inflation into account, this represents a reduction of 5.5% in average earnings. As noted above, Glasgow has seen a smaller than average reduction in firm and solicitor numbers; this impacts on the calculation of averages.
37. What is apparent is that each of the sheriffdoms has reacted differently over the last 5 years. The market for criminal legal services in Scotland can be described as segmented. Regional differences exist between sheriffdoms in regards to the types and numbers of firms undertaking criminal legal services and the volume of particular types of work being generated.
38. To some extent, these differences appear to be demand driven. For example, firms in Glasgow derive a more significant share of their overall income from solemn legal aid than other parts of the country. In the four years prior to summary justice reform, solemn comprised around a third of all fee income in Glasgow, compared to around a quarter in every other sheriffdom.
39. However, other variations appear more to do with the development of different local cultures. For example, advice and assistance has been a more significant component of summary criminal income in Glasgow than in other parts of the country. The change in the treatment of advice and assistance in summary cases has therefore had a differential impact across the country.
40. Regional variations indicate that where firm numbers have reduced, significant gains in average firm revenues and potentially profits per partner have arisen. Market restructuring in these areas has therefore acted to sustain and develop firms' potential profitability at a time of overall expenditure reductions.