Department
for Education

Review of childcare costs: an executive summary of the analytical report

An economic assessment of the early education and childcare market and providers' costs

25th November 2015

Reference: DFE-00296-2015

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Foreword – Sam Gyimah MP, Minister for Childcare and Education

I welcome this review which delivers on our general election commitment to assess the cost of childcare provision in England. The report gives us a rich, detailed and clear understanding of the early education and childcare market. I am extremely grateful to all of the providers, provider representatives, and other individuals and organisations that have contributed to making this so in depth and comprehensive.

The findings of the review – the first of its kind by government – have formed the evidence base for our decisions at the Autumn 2015 Spending Review. On the basis of this review, I am pleased to be able to confirm that the government is allocating funding for a substantial uplift to the funding rate. We will be investing over £1billion more per year by 2019-20, including £300 million for a significant uplift to the rate paid for the two-, three- and four- year-old entitlements. The new rates will be £4.88 for three- and four-year-olds, including the EYPP,[1] and £5.39 for two-year-olds. This shows the importance government attaches to funding high-quality childcare. We are confident that, on the basis of this review, this new rate will underpin sustainable delivery of the entitlements – including the new 30 hour entitlement for three- and four-year-olds for working families.

Our support for the industry isn't just about providing more money through the uplift. Alongside it we are announcing a package of reforms that will support successful delivery of the entitlements. We know that the current funding system creates unfair and unjustifiable differences between areas, and between types of providers.

We are committed to introducing a fairer and more transparent way of distributing funding for the entitlements, which will see more funding passed on to providers at the front line. We will consult on proposals to do this in the new year.

The review has also shown that some business models do not make full use of the flexibility in the regulatory system – and that high-quality provision can be delivered by providers that do use this flexibility. We are clear that the funding rate will enable providers to deliver high-quality places in line with statutory requirements alongside the introduction of the new National Living wage.

Providers have informed us that there can be unnecessary bureaucracy involved in delivering the entitlements. We will work to simplify and limit the conditions local authorities can place on providers delivering the free entitlement, and will work with the sector to reduce unnecessary bureaucracy that limits the time staff can spend with children. We will begin early implementation of the 30 hours entitlement in a small number of areas from September 2016. The Early Implementers programme will give us an opportunity to test capacity, flexibility and importantly innovation, as well as ensure that all eligible children, including those with special educational needs, can access the 30 hours.

This is an exciting time for the childcare sector with more government investment than ever before going towards helping parents with the cost of living, supporting them to work more hours and for children to benefit from high quality early education.

1 Early years pupil premium

Executive summary

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Acknowledgements

This review has been written by the Department for Education, with advice and support from across Government.

The review team would like to thank the childcare providers, their representatives and other interested parties that engaged so constructively with the review, and were so generous with their time. This includes the more than 2,000 organisations that responded to the Call for Evidence; those that responded to our follow-up survey; and the more than 100 that attended roundtable discussions across the country. We would particularly like to thank the Pre-school Learning Alliance, the National Day Nurseries Association, PACEY, the Independent Schools Council and other key partners for being so generous with their time.

Deloitte were engaged to support work led by the Department for Education, specifically around understanding the different cost pressures faced in different parts of the market through both a review of the published literature as well as primary research directly with providers; and to engage with providers to help inform the overall review. The Department for Education have interpreted these findings and research to inform this review.

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Purpose of the review

From September 2017, three- and four-year-olds in working families will be eligible for up to 30 hours per week of state-funded childcare. This represents a major expansion in the 'free entitlement', building on the existing, universal three- and four-year-old early education entitlement; and the two-year-old entitlement for disadvantaged children.

It is essential that all of these entitlements are funded properly, at a level that enables providers to deliver the good-quality early education and childcare that benefits children, meets the needs of parents, and which is fair and sustainable for the taxpayer. The government commissioned this review of the cost of providing childcare for pre-school age children in order to provide a sound analytical underpinning to inform what this rate should be.

As a major purchaser in the childcare market, government also wanted a better understanding of the state of the market, its strengths and weaknesses and to learn about the business practices of the most efficient providers in the market.

The review has been analytically-led and evidence-based. It has been worked on by a team of DfE analysts, led by the Department's Chief Analyst, and supported by expertise from across government and outside.

The review examined the costs of childcare provision at provider level and considered all available evidence on the current demand for and supply of childcare places for two-, three- and four-year olds.

It has also considered how government regulation and funding has shaped the market. We have looked at the provision for children with additional needs and how this varies across the market.

Although the review focusses on the current costs of provision, it also examines the implications of future cost pressures facing the sector, in particular the introduction of the Living Wage from 2017.

The review is based on the best evidence available, including additional evidence collected throughout the review. The evidence used to inform the review is outlined in Section 2 and the appendix of the main document.

The Department is pleased with the engagement it has had from across the childcare market. Its Call for Evidence received over 2,000 responses between 15 June 2015 and 10 August 2015, with the majority of responses submitted coming from providers.

The Call for Evidence was supplemented by a series of roundtable events with providers, provider representatives, and academics. Events were held at DfE offices in London, Sheffield, Manchester and Coventry. We held particular thematic discussions on childcare for children with additional needs, including those with Special Educational Needs and/or Disability (SEND) and those from disadvantaged backgrounds; and held a roundtable event just with childminders.

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Childcare market segmentation

This review focusses primarily on provision of early education and childcare for two-, three- and four-year-olds. The childcare market is diverse and we have focussed on the following ‘segments’ of provision:

Group-based provision

Private nurseries: These providers are for-profit entities. Typically, they offer the free entitlement and provide a flexible mix of sessions. They tend to have children across all (pre-school) age groups, and include nurseries based on school sites.

Voluntary nurseries: This segment has a range of voluntary providers, including not-for-profits and social enterprises. These are typically open term-time only, although some also offer out-of-school and holiday care. Voluntary providers do not necessarily own their premises – they may operate out of church halls, community centres, school sites, etc.

Independent school nurseries: These are independent schools with nurseries for children under five.

Primary schools with nursery provision:[1] This segment typically offers morning and afternoon sessions for early education and childcare, with some offering only the free entitlement for children. Typically they have children aged above two years. They generally operate at lower staff to child ratios[2] than private and voluntary providers, with more qualified staff, but still above the statutory requirements. As they are based on school sites, the overhead costs are shared with the rest of the school.

Maintained nursery schools: This segment typically operates in areas of greater disadvantage and are designed to support early education and childcare in these areas. They operate on standalone sites, and are funded by the local authority. Many maintained nursery schools are attached to children’s centres as required by their local authorities.

Home-based provision

Childminders: They comprise the largest share of the market in terms of absolute numbers of providers. However, their share of places are limited as most childminders operate alone and are restricted by the 1:3 staff to child ratio requirements for children under five. They operate out of their own domestic premises.

1 These will be referred to as ‘primary school nurseries’
2 Lower staff to child means fewer staff per child

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Current market strengths and weaknesses

Market assessment

The childcare market is very complex, with a wide range of different types of providers and contexts. The wide variety in types of provision, and different business models for delivering childcare, is striking.

Our overall assessment is that the market appears to function reasonably effectively. However, there is scope for providers to use all the flexibility available to them in order to improve the sustainability of their business and deliver for parents and children.

The key strengths and weaknesses of the market, as we found them, are summarised here.

Market strengths

Supply in the market is healthy, and has grown in recent years. Evidence suggests there is currently sufficient supply available to the majority of parents.

Government has invested considerably in this market – spending on childcare support had increased to £5billion a year by the end of the last Parliament. This has boosted demand for places and provides a guaranteed income to providers.

Most providers report breaking even or making a profit, and exit rates from the market are low. Parents tend not to switch providers frequently. This indicates parental satisfaction with provision, although we recognise the high costs to switching.

Government regulation appears proportionate and is not the key constraint on behaviour. In particular, the vast majority of providers reported that they are not constrained by government in the staffing models they choose (in respect of both qualification levels and staff to child ratios).

Nevertheless, some providers have reported that complying with regulation is complex and costly. Some have also highlighted the high administrative costs of dealing with their local authority in securing funding for the free entitlements and to cover costs associated with children with additional needs.

Barriers to entry and exit appear moderate to low and many providers report a real commitment to providing education and care to children as a key reason for staying in the market.

Quality in general, as reported by Ofsted is high.[1] In 2015, 85% of two-, three- and four-year-olds receive their funded early education in settings rated good or outstanding by Ofsted.

1 This is where Ofsted judgements are known

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Current market strengths and weaknesses

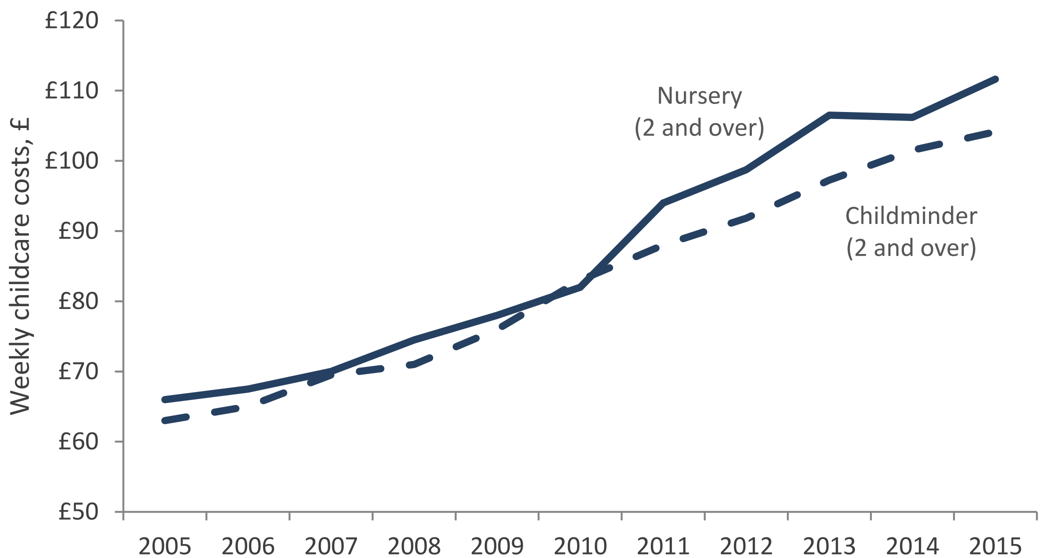
However, the market also has some clear challenges

The childcare market is highly fragmented. Provision is very localised. It is a relatively labour intensive industry, with mostly small, single-site providers with limited scale economies.

Across the board, there are successful providers of varying scale. However, the cost of childcare has continued to increase, which raises questions as to whether providers can operate more efficiently in order to deliver value for money.

Formal childcare prices to parents have outstripped inflation over the past decade. The average market price paid for nursery provision for children aged over two has risen by 69% in the last ten years. During this time period, Consumer Price Inflation (CPI) has been only 28%. One in five parents who have not accessed formal childcare cite cost as the key barrier.

Typical weekly childcare fees for a full-time nursery or childminding place[1]



Percentage change in childcare fees and CPI inflation between 2005 and 2015[2]

Type of provision	Change
Nursery (under 2s)	66%
Nursery (2 and over)	69%
Childminder (under 2s)	59%
Childminder (2 and over)	65%
CPI headline inflation	*28%*

1 Family and Childcare Trust's annual surveys: Over the years there have been some tweaks to the definitions and coverage of the FCT survey, so assumptions have been made to create a consistent time series

2 Family and Childcare Trust's annual surveys; Office for National Statistics http://www.ons.gov.uk/ons/rel/cpi/consumer-price-indices/october-2015/tsd-consumer-price-indices-october-2015.html

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Scope for efficiencies and learning from best practice

Looking across providers, there is scope for efficiencies in the staffing model, and specifically staff to child ratios. Providers typically use more staff than government regulations require. They report, in part, that this is a quality measure, and that ‘slack’ is needed to enable them to cover peaks and troughs in demand. Where providers are operating with ‘slack’ in the system, they incur higher costs.

Parental demand does not appear to be a factor in encouraging this common practice. There is evidence that higher quality can be achieved by providers operating close to or at statutory ratio. Graduate led settings such as school nurseries operate at high ratio and in general have a reputation for high quality.

Our analysis shows that a ‘typical’ provider in a private setting could save around 15% of its unit delivery costs by staffing within the statutory requirements. Similarly, there are potential savings by changing the mix of staff used, within the limits of regulation. Potentially big savings are available using more variable staffing models to recognise peaks and troughs in occupancy. Increasing overall rates of occupancy improves efficiency for the same reasons – spreading costs over a higher number of funded or paid for places.

To a lesser extent, we also consider that some providers would benefit from economies of scale (using any spare capacity within premises, for example) and of scope (using premises to care for other age groups of children or sharing back-office functions with other providers, for example).

Not all of these efficiencies are available to all providers but close examination of ‘typical’ business practices suggest considerable potential for efficiency across the market as a whole.

The next two slides explore the various sources of efficiency we have observed and provides some explanation and quantification of these, where that has been possible.

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Efficiencies from staff deployment

Unit costs vary considerably by staff deployment

Our analysis shows that hourly costs can be reduced where providers deploy staff efficiently within statutory limits.

The table below shows the costs for the commonly reported staff to child ratios used in practice by providers.

For private and voluntary providers these are: 1:6 (the average) or 1:8 (the statutory minimum) for three- and four-year-olds; and 1:3.2 (average) or 1:4 (statutory minimum) for two-year-olds. School providers more typically report using a 1:10 (average) or 1:13 ratio (statutory minimum in a graduate-led setting). The estimates account for all overheads but staffing requirements constitute by far the largest share of total costs across all provider segments.

Those providers that staff at a higher ratio of staff to children (i.e. have fewer children per staff member) are incurring significantly higher costs. They are also foregoing significant revenue. Assuming a price of £5 per hour per child (of any age), the revenue per staff member generated for two-year-old provision in a private setting is £16 with the higher staff to child ratio compared to £20 per hour for the lower one. For three- and four-year-old provision, the revenue per staff member varies from £30 an hour to £40 an hour for the higher and lower assumed staff to child ratios respectively.

There are a number of existing published estimates of unit costs that we consider for comparison in section two of the main report. Estimates vary according to assumptions on providers' business models. We believe the estimates provided here at the statutory ratios provide a good set of unit cost benchmarks.

Representative costs per contact hour, England 2014/15 (staff to child ratio in parentheses)

Core provider segment	Aged two		Aged three and four	
	Hourly cost at average ratios	Hourly cost at statutory ratios	Hourly cost at average ratios	Hourly cost at statutory ratios
Private	£5.87 (1:3.2)	£5.00 (1:4)	£4.25 (1:6)	£3.56 (1:8)
Voluntary	£5.39 (1:3.2)	£4.54 (1:4)	£3.81 (1:6)	£3.14 (1:8)
Primary schools with nursery provision	-	-	£4.37 (1:10)	£3.60 (1:13)

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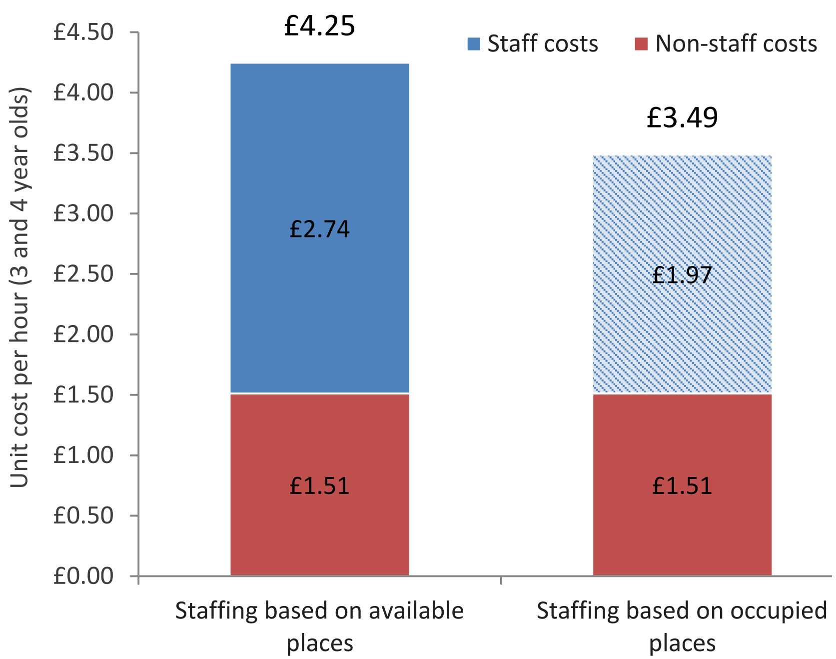
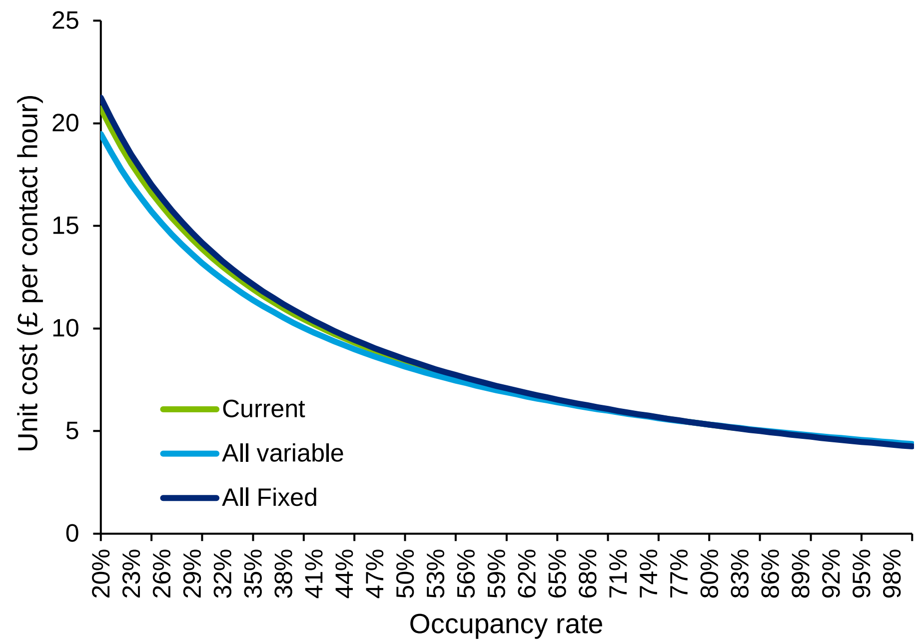
Efficiencies through flexible staffing models, increasing occupancy and diversification

1) **Flexible staffing models** – matching staffing more closely to occupancy levels decreases cost. The chart below shows savings up to 18% from matching staff levels fully to occupancy levels.



2) **Increasing occupancy rates** - attracting children on quieter days of the week lowers unit costs, for example by lowering prices for parents on such days. Unit cost estimates fall by up to 26% if a private provider was able to operate at 100% occupancy compared to 72% occupancy.[1]



3) **Economies of scale** - most providers in the market are small in scale. Although most costs are variable, there can be scope to spread overhead costs where building space can be used to deliver more than one type of childcare provision, for example by providing before and after school clubs.

4) **Economies of scope** - economies of scope can also be realised by nursery chains, sharing managerial and back office functions. School-based settings may also benefit from economies of scope as being co-located with a school enables sharing of staff and administrative functions.

1 We recognise that 100% occupancy is not realistic but this analysis illustrates the range of savings available for providers who can increase their occupancy.

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Conclusions

This review gives government a solid evidence base for the purposes of setting a funding rate for the entitlement.

Ministers are now in a much stronger position to make decisions about a funding rate which is fair to providers, parents and the taxpayer. In making these decisions there are a number of other factors that have also been considered.

The review has found that different types of providers (private, voluntary, school-based nurseries etc.) have different cost bases. However, it found greater variations between providers of the same type than across providers, depending on business practices adopted, geography, size of setting and so on.

The review has provided strong evidence that cost bases vary substantially across different parts of the country. In particular, staff salaries are considerably different between regions. There is, therefore, a strong evidence case for varying funding rates between areas.

This review has concentrated largely on the delivery costs of providing childcare, but we also considered the need for providers to earn a reasonable profit margin, sufficient to make setting up and running a business in the childcare market worthwhile. However, the entitlement cannot cover all of the additional extras some providers and parents might choose. The Department's statutory guidance already spells out that "this document does not provide guidance on how providers operate their private businesses, including charges for provision over and above a child's early education place."[1]

The review has shown that there is considerable scope for providers to become more efficient in their practice, in order to manage their costs within the available revenue. For example they could substantially reduce their unit costs by operating within statutory staffing ratios – for three- and four-year-olds, either 1:8 or 1:13 with a graduate-qualified member of staff present, and 1:4 for two-year-olds.

There is potentially scope for improving average levels of occupancy, and for providers to flex their staffing in less busy periods of the year – in particular, we anticipate that providers will do this in order to help meet any increase in costs over time, particularly the National Living Wage.

Early years funding is distributed via local authorities, who retain a proportion of funding to enable them to centrally administer the free entitlement, and other services. The level of central spend retained varies by each local authority. The funding rate also includes the margin needed for local authorities to perform this function.

1 Department for Education – Early education and childcare, statutory guidance for local authorities